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The Case for a Capital Gains Preference

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B. Would an Increase in Private Savings Translate into an Increase in Domestic Investment?

I. INTRODUCTION

For years, the authors have taught their students that we could identify no substantial argument to support a preference for capital gains in a tax system with Haig-Simons income as the normative tax base.\(^1\) Indeed, the arguments against the preference were so strong that it was hard to construct a competing claim. Although we acknowledged serious flaws in the current treatment of capital gains, we asserted that a preference appeared to be a very poor solution to any of these problems.

This Article undertakes to examine that conclusion. The arguments we consider were first and ably catalogued by Professor Walter Blum more than 35 years ago.\(^2\) His "handy summary" remains a classic, and makes a persuasive case that the arguments in favor of a preference are weak. Nevertheless, a capital gains preference continues to garner much support in political circles. We re-examine those arguments taking into account the learning of the last three decades. On one level, our analysis confirmed our intuition. We found all arguments favoring the preference wanting. Each serious contention reacts to a flaw in the current treatment of capital gains that stems from the realization requirement. In each case, there is a solution that is far superior to a capital gains preference.

These solutions are well known and have been debated for years. Their adoption by Congress, however, does not appear to be imminent. This reality prompted us to analyze each argument on a second level. We considered whether, if the optimal solution were unavailable, a capital gains preference would be a sound second-best approach.\(^3\) In all cases, save one, we find that a preference is not a

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1 Throughout this article, we use “preference” to refer to the beneficial treatment of capital gains. This preference can be expressed either as an exclusion of some portion of the gain, see, e.g., IRC § 1202 (before amendment in 1986), or a preferential rate of tax, see, e.g., IRC § 1(h).

A rate preference can be translated into an equivalent exclusion by the formula: exclusion = (top marginal rate - preferential rate)/top marginal rate. A preferential rate, however, unlike an exclusion, has ripple effects. For example, inclusion of a taxpayer's entire capital gain in gross income affects adjusted gross income and therefore, certain deduction limitation sections. See, e.g., IRC §§ 67(a), 68(a), 165(h), 170(b)(1), 213(a). Nevertheless, the case for a capital gains preference in no way depends on the form of the preference.


3 Throughout this Article, we are required to consider possible application of the theory of second best. See R.G. Lipsey & Kelvin Lancaster, The General Theory of Second Best, 24 Rev. Econ. Stud. 11 (1956). In general, the theory (or paradox) of second best is that
tolerable second-best alternative. However, as a second-best response to lock-in—the incentive created by the tax law to retain assets, preferably until death—a capital gains preference may be acceptable.

Undoubtedly, there is a tax rate on capital gains that maximizes federal revenue. Imperfections in current law make it relatively easy to avoid paying tax on capital gains. Thus, one might expect the revenue-maximizing rate on capital gains to be below the general rate imposed on ordinary income in order to induce taxpayers to realize gains that they otherwise might easily avoid. Most empirical studies addressing this issue imply that there is a rate that would maximize revenues by increasing realizations and that it is probably below the general rate. Thus, taxing capital gains at a rate below the rate on ordinary income is likely to raise more revenue than taxing all income at the same rate. We reject, however, the premise that a tax is per se acceptable because it raises the needed amount of revenue, and instead, we evaluate the preference on efficiency and equity grounds.

Although complexity attributable to the preference is a significant offsetting factor, the preference might be efficient if it resulted in taxation of capital income at the revenue-maximizing rate. Whether a preference is unambiguously equitable is a much more difficult question. Although a preference could never be supported on equity grounds in designing a tax system, we find a stronger case can be made for the equity of a preference as a reform proposal. While we accept the classic standard of equity—equal incomes should bear equal burdens—as necessarily following from vertical equity in designing an income tax, we suggest that such a standard should not be the sole determinant in evaluating a reform proposal. Rather we assert that the proper inquiry is whether the distribution of the tax burden after the reform would be more in accord with how the tax burden would be distributed under an ideal income tax. We believe a strong case can be made that, on certain assumptions, a capital gains preference is an equitable reform proposal. Therefore, we argue that a capital gains preference might be supported both because it is efficient and because, in a second-best world, it promotes equity.

the perfect solution in an ideal world may be a very poor solution in a less than ideal world. Furthermore, a poor solution in an ideal world may be the best solution in a less than ideal world. In the context of this article, this theory would hold that, even though an ideal income tax clearly would give no preference to capital gains, deviations from the norm require the preference to offset these other imperfections. As one commentator put it, "in other words, two wrongs may be the next-best thing to a right." Richard L. Schmalbeck, The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best?, 48 Tax Notes 195, 199 (July 9, 1990) [hereinafter Uneasy Case]. Another way of stating the argument is that, given prior decisions to deviate from a Haig-Simons base, a preference actually might move the system closer to, rather than farther away from, the norm.
The final Section considers the preference as a savings incentive and concludes that the argument that a capital gains preference would stimulate economic growth is not very compelling. Its validity depends on the extent to which a preference would increase domestic investment, which is dependent on whether the preference would pay for itself through increased realizations.

Thus, the soundness of both the strongest argument for a preference in a normative income tax as well as the argument for economic growth hinges on empirical data shrouded in doubt. Ultimately, support for the preference depends on one’s willingness to rely on ambiguous evidence and one’s steadfastness in holding out for optimal solutions.

II. THE ORIGIN OF THE PROBLEM: THE IMPERFECT TREATMENT OF CAPITAL GAINS UNDER CURRENT LAW

In large measure, the arguments proffered for preferential treatment of capital gains derive from their imperfect treatment under current law. Under the Haig-Simons formulation of the normative base, income is a taxpayer’s consumption plus change in wealth for a particular period.4 The normative treatment of the income produced by an asset for any tax period is an ex post accounting of its change in value. The tax is levied at the same rate as that applied to all other types of income.

There are at least four major ways in which the current treatment of capital gains diverges from this ideal—all attributable to the realization requirement. First, gains and losses generally are not taken into account as they accrue, but only when they are realized. Although the realization rule theoretically defers both gains and losses, as a practical matter, its primary impact is to defer gains. Taxpayers control the timing of realization, and they tend to realize losses as they accrue while deferring gains. In most cases, tax on accrued gain is deferred only until the asset is sold, exchanged or disposed of,5 but in some

4 Robert M. Haig, The Concept of Income—Economic and Legal Aspects, in The Federal Income Tax 1, 7 (Robert M. Haig ed., 1921), reprinted in Am. Econ. Ass'n, Readings in the Economics of Taxation 54 (Richard A. Musgrave & Carl Shoup eds., 1959); Henry C. Simons, Personal Income Taxation 50 (1938). The treatment of the gain or loss from the disposition of a capital asset is only an issue in an accretion-type tax system; it does not arise in a system that uses consumption as the base. We employ the Haig-Simons base because there is a widely-held view, to which we subscribe, that this base is the best starting point for a definition of income in an accretion-type tax system. This issue is discussed further at text accompanying note 200.

5 On average, only 3.1% of accrued gains are realized in any given year. Jane G. Gravelle & Lawrence B. Lindsey, Capital Gains, 38 Tax Notes 397, 400 (Jan. 25, 1988).
cases tax can be deferred even longer. The realization requirement has spawned loss limitation rules to prevent taxpayers from zeroing out income by realizing accrued losses while holding appreciated assets (often until death). Other loss limitation rules serve additional functions, but also move the tax system away from the norm.

A second divergence greatly magnifies the impact of the realization rule. The current rules that death is not a realization event and that a beneficiary takes a fair market value basis in property acquired from a decedent effectively exempt most capital gains from taxation. Both rules are extraordinarily beneficial to taxpayers. For example, if the nominal rate of tax is 28%, and the taxpayer is able to defer tax on a capital gain for 10 years, the effective rate of tax is reduced to 19%. If the asset is held until death, the effective rate is zero. A taxpayer can obtain this advantage even if he economically enjoys the value of the appreciation during life, for example, by borrowing against the security of an asset that is held until death.

Two other departures from the Haig-Simons ideal partially offset the benefits produced by these two divergences. First, because basis is not indexed for inflation, nominal gains always exceed economic gains. This factor can be quite important, especially during periods of high inflation such as the late 1970's. The failure to index requires many taxpayers to pay tax on inflationary gains that actually represent gains during life.

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6 See, e.g., IRC § 408(d) (no tax on gain on assets retained within an IRA); IRC § 1031 (deferral of gain on asset swapped for like kind asset); IRC § 1033 (deferral of gain on involuntary conversion if proceeds are invested in similar asset); IRC § 1034 (deferral of gain on sale of principal residence if proceeds are invested in another principal residence).

7 Under current law, an individual in any taxable year can deduct capital losses only to the extent of capital gains plus $3,000. IRC § 1211.

8 See, e.g., IRC §§ 465, 469.

9 For example, § 469 prevents current deductibility of losses that demonstrably have been sustained economically.


11 IRC § 1014.

12 Approximately one-half of all accrued capital gains are held until death and are never taxed. Mervyn A. King & Don Fullerton, The Taxation of Income from Capital 221 (1984). Even fewer capital gains on owner-occupied housing are subject to taxation. Gravelle & Lindsey, note 5, at 398.

13 This assumes a 4% real after-tax rate of return. If the taxpayer were able to defer payment of $28 for 10 years, the present value of that payment, discounted at 4% annually, would be $19.

14 The effective rate on capital gains is perhaps one-quarter to one-third of the statutory rate on average (ignoring inflation). The Capital Gains Controversy: A Tax Analysts Reader 1, 1 (J. Andrew Hoerner ed., 1992) [hereinafter Capital Gains Reader].

15 See Woodsam Assocs. v. Commissioner, 198 F.2d 357 (2d Cir. 1952) (receipt of a nonrecourse mortgage in excess of basis does not trigger gain).
The second deviation stems from the imposition of a double tax on corporate earnings. Under current law, corporate income is taxed twice, first at the corporate level, and again when the income is distributed (or in the case of retained earnings, when the underlying stock is sold or redeemed).

Taken together, these aberrations result in almost total mismeasurement of income from capital assets. Countless opportunities exist to take advantage of the failure to account for the gain accurately. Boundless complexity follows. Without question, provisions that might ameliorate the distortions are warranted. The next Section of the Article considers what those provisions should be and especially whether a capital gains preference is one of them.

III. CAPITAL GAINS IN A NORMATIVE INCOME TAX

Most of the plausible arguments in favor of a capital gains preference are directed at one or more of the flaws in the current treatment of capital assets. In this Section, we carefully consider the arguments advanced in favor of a capital gains preference as a means of addressing the problems caused by deviations from the base. Several of the arguments are specious and we address them briefly in the next Section. We find no need to examine possible solutions because we find no problem.

The subsequent Sections detail more serious arguments. In each case where a problem actually exists, it is clear that it arises from the failure to treat capital gains in the theoretically correct manner. In designing an income tax system, conformity to the Haig-Simons ideal always would be preferred; that is, there is no case for a capital gains preference as a design choice. A capital gains preference is, however, a tax reform rather than a design proposal. Thus, it only arises as a serious option once the decision has been made to vary the definition of income in ways contrary to the Haig-Simons ideal.

The usual discussion of capital gains treats the preference as an original design question and assumes a multiplicity of choices. We presume, however, that prior choices have been made: Bowing to pragmatism and political reality, we accept that the optimal solutions are not forthcoming. That is, we take as given the realization rule, § 1014, the failure to index for inflation and the absence of integra-

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16 Another mistake partially compensates a seller who originally borrowed to fund the purchase of the asset. The taxpayer will have enjoyed inflated interest deductions that are offset only on the sale by the inclusion of an equally inflated sum in his amount realized with respect to the outstanding principal amount of the debt.

tion, and we address only one option. If the only reform option were a capital gains preference, would it be supportable and preferable to current law? Taking the Haig-Simons formulation as normative, the issue is whether a capital gains preference—as a second-best alternative—would move the tax system closer to the norm.\textsuperscript{18} The current treatment of accrued gain is a “mistake,” but it does not follow that another mistake, the capital gains preference, necessarily would move the system further from the ideal. Taking the first distortion as a given, yet another distortion might be an improvement, even if it does not return the system to the ideal state.\textsuperscript{19}

Thus, in each case we evaluate the preference not from the perspective of normative first principles, but rather from the perspective of whether it would bring an already defective system closer to the ideal. As a solution to all problems save one, the capital gains preference, as currently structured, is unsuitable. As a solution to lock-in, however, a capital gains preference may be tolerable.

\textbf{A. Capital Gains Are Not Income}

Several of the traditional arguments in favor of a preference essentially are definitional.\textsuperscript{20} They range from the conclusive (“capital gains are not income”)\textsuperscript{21} to the completely specious (“people do not regard capital gains as income”)\textsuperscript{22} to the slightly serious. Their gist is that capital gains are unexpected, nonrecurring receipts, wholly unlike wages or other payments for productive effort.\textsuperscript{23}

This view is misplaced. The argument that capital gains are not income might be relevant in a tax design debate, but as previously noted, a preference is a tax reform issue. Even as a design argument,

\begin{footnotesize}
\begin{enumerate}
\item[19] Id. at 1204 n.62 (stating that a particular distortion may have a net anti-distortive effect in light of other distortions).
\item[20] The first 10 arguments catalogued by Professor Blum, note 2, fall into this category.
\item[21] Id. at 248 (argument 1). A similar argument is a “tax on capital gains is a tax on capital.” Id. (argument 2). As Professor Blum points out, this simply may be a poor formulation of other arguments. Id.
\item[22] Id. at 249 (argument 6). Other arguments that fall into this category would include “[capital gains are not treated as income under the British income tax],” id. at 248 (argument 3); “property laws class capital gains not as income but as accretions to capital,” id. (argument 4); and modern financial accounting does not treat capital gains as ordinary income,” id. at 249 (argument 5). We do not think any of these arguments deserve further comment. Professor Blum dispatched them adequately.
\item[23] These arguments include “capital gains are not recurrent,” id. at 250 (argument 7); “capital gains by and large, are unexpected,” id. at 251 (argument 9); “[capital gains generally are not due to deliberate economic activity or productive effort,” id. (argument 10).
\end{enumerate}
\end{footnotesize}
however, it is unpersuasive. It is based on an unsophisticated view of income and ignores Simons' admonition against taking the source of income into account. Furthermore, for most taxpayers, capital gains are expected and recurrent. Moreover, even assuming that capital gains were nonrecurrent and unexpected, those attributes do not call for special tax treatment. In fact, in the classic case of a one-time extraordinary receipt, such as treasure trove or windfall, the tax system subjects the recipient to tax at ordinary rates. Furthermore, to the extent this argument relies on the "unexpected" nature of the receipt, it is particularly weak because imposition of the tax could not affect behavior. In short, nothing inheres in the nature of a capital gain that warrants treating it differently from other sources of income.

B. Consumption and Not Income Should be Taxed

Commentators sometimes argue that because the ideal tax base is consumption, and not income, a preference comes fairly close to the correct treatment of capital gains. Under a consumption tax, the income from capital would be taxed only if it were used for consumption and thus, would be excluded from the base if not consumed. Exclusion of a portion of the gain is, therefore, closer to the correct treatment than is full taxation. This argument often is supported by

24 On several occasions, the Supreme Court has rejected the notion that capital gains are not income. See, e.g., Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921).
25 Simons, note 4, at 50.
26 Reg. § 1.61-14(a); Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).
the observation that our current system is a hybrid with aspects of both a Haig-Simons base and a consumption tax base.

Obviously, if one advocates a consumption tax, the only truly satisfactory solution is to change the base.30 It is clear, however, that Congress nominally has chosen a tax based on income and that deviations from that base are the source of much inefficiency and complexity. Although it is true that the current base is a hybrid, most deviations from the income tax base are explainable, either as being administratively required,31 or as promoting competing public policies.32 In this context, the preference raises two questions: 1) Is there any reason to single out investments in capital assets, as defined, for consumption treatment? and 2) If so, are the benefits from this special treatment worth the complexity that surely follows?

As to the first issue, we claim that no argument supports the preference as a matter of tax design. Furthermore, there is no reason why “capital assets,” and not all assets, should be eligible for consumption treatment. As to the second, a preference for certain investments and not others undoubtedly distorts the allocation of resources, resulting in inefficiencies, and intensifying complexity as taxpayers seize resultant opportunities for arbitrage. To illustrate, suppose interest were deductible without limitation33 and a 50% exclusion for net capital gains were enacted. Consider T, who purchases an asset with borrowed funds for $100, paying interest at the rate of 10% per year; which is also the rate at which the asset is expected to appreciate. After one year and a day, T sells the asset for a $10 gain with which he pays the interest on the loan. Although he has broken even economically, for tax purposes, because one-half the gain is excluded, T has a loss of $5. The cost of eliminating this arbitrage with provisions patterned on § 163(d) is considerable complexity. In sum, if consumption tax treatment is not extended universally, this movement in “the right direction” may produce worse results than no movement at all.

30 The wisdom of such a change is beyond the scope of this article.

31 For example, excluding the imputed income from owner-occupied housing has been justified on administrative grounds. See, e.g., Staff of Joint Comm. on Tax’n, 103d Cong., 1st Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1994-1998, at 3-4 (Comm. Print 1993).


33 Under current law, the deduction for interest is often limited. See, e.g., IRC §§ 163(d), (h); 469. These limitations narrow, but do not eliminate, the arbitrage discussed in the example in the text.
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C. Bunching

Essentially, the bunching argument is that the realization rule forces a taxpayer to report in one year capital gains that have accrued over several years and may subject the gains to a higher marginal rate than would have applied had the gains been reported each year as they accrued. A preference acts as a crude averaging device to offset the telescoping effect of the realization requirement. To illustrate, consider the following:

T purchased X stock 10 years ago for $10. During each of those 10 years, T was in the 25% tax bracket. This year T sold the stock for $510, recognizing a gain of $500. As a result of this gain, T is pushed into a higher bracket and must pay taxes on the gain at a 40% rate.

Bunching is a potential problem only in a system with graduated tax rates and only if the taxpayer is in a higher bracket on the disposition date than she was when the income accrued. Thus, for example, if the $500 gain is taxed at a 40% rate, T would owe $200 in taxes, compared to the $125 she would have owed if the gain had accrued at $50 a year for 10 years and had been subjected to a 25% rate.

The chief flaw with the bunching argument is that it fails to take into account the benefit T enjoys from deferral. While it is true that T's tax liability in absolute dollars is higher than it would have been if the gain had been taxed on an annual basis, T has deferred the liability throughout the period her economic income accrued. Depending on the assumptions, the deferral resulting from the realization requirement may offset the bunching effect completely.

Bunching currently is not a significant problem. Most capital gains are realized by taxpayers already in the highest bracket; therefore, at

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35 Assume, for example, that the gain accrues at the rate of $50 a year. If it had been subject to tax on accrual at a 25% rate, an annual payment of $12.50 would have been required. The present value of a 10-year $12.50 annuity at a 7.5% after-tax discount rate is $85.80. The present value of a single $200 payment (a $500 gain taxed at 40%) in year 10 is $97.03. Thus bunching increases the obligation by only 13%, rather than by 60% as nominally appears. If the discount rate is higher or the deferral period longer, the value of the deferral may fully offset the bracket elevation.

36 Statistics from 1989 federal income tax returns indicate that 83% of net capital gains are reported by those whose adjusted gross income (AGI) exceeds $50,000 and 56% of net capital gains are reported by those with AGI exceeding $200,000. Returns showing $200,000 of AGI represented only 5.34% of all individual returns filed, however. Internal Revenue Service, Statistics of Income 1989: Individual Income Tax Returns 27 (1992).
least for these taxpayers, taxing capital gains on realization rather than accrual does not force them into a higher bracket. This is especially true in periods when the brackets are flat, the top marginal rate is reached at a relatively low threshold of taxable income and most taxpayers with investments are in the same bracket. Furthermore, a gain that is small relative to total income may not move the taxpayer into a higher bracket. Even if the gain is large compared to total income, there may be no effect from bunching if other multiple gains are spread approximately equally throughout the period.

On the other hand, there are taxpayers who experience bunching. A taxpayer below the highest bracket may incur an irregular capital gain—for example, the once-in-a-lifetime sale of stock to fund a college education—that will be taxed at the top marginal rate. This

Similar patterns held in previous years. See Allen D. Manvell, Basic Statistics on Capital Gains, in Capital Gains Reader, note 14, at 11; see also Albert J. Davis, Measuring the Distributional Effects of Tax Changes for the Congress, 44 Nat'l Tax J. 257, 259-60 (1991) (multi-year research shows capital gains preference benefits those with income exceeding $75,000). If taxpayers are tracked over several years, the percentage held by the upper income classes is somewhat lower, but still quite high. See Gerald E. Auten & Joseph J. Cordes, Policy Watch: Cutting Capital Gains Taxes, 5 J. Econ. Persp. 181, 187 (1991). See also George R. Zodrow, Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity, 48 Tax L. Rev. 419, 484-90 (1993) [hereinafter Economic Analyses] (examining distributional studies and concluding that although one-time gain inflates measured income, gains on average are highly concentrated in high income individuals).

Politicians often confuse the number of taxpayers who have capital gains with their share of gains. While low and middle income taxpayers comprise the bulk of taxpayers realizing gains, high income taxpayers realize the bulk of the dollar amount of gains. Manvell, supra, at 10.

37 In the first two years of the income tax, 1913-1915, there were six brackets, in which the applicable tax rate ranged from 1% to 6%. Income Tax Act of 1913, ch. 16, § 2, 38 Stat. 114, 166. From 1915 until 1986, the number of brackets increased. In 1916, the brackets remained flat at the bottom, but ranged from 6% to 15% at higher incomes. Revenue Act of 1916, ch. 463, § 1, 39 Stat. 756, 756. In 1917, brackets also became less flat at lower incomes, remaining relatively flat only in the middle income ranges. Revenue Act of 1917, ch. 63, § 1, 40 Stat. 300, 301. From 1918 to 1924, brackets were extended. Revenue Act of 1918, ch. 18, § 211, 40 Stat. 1057, 1063-64; Revenue Act of 1921, ch. 136, § 211, 42 Stat. 227, 233-37. From 1925 to 1931, brackets were relatively flat for middle and high income taxpayers. Revenue Act of 1924, ch. 234, § 211, 43 Stat. 253, 265-67; Revenue Act of 1926, ch. 27, § 211, 44 Stat. 9, 21-23; Revenue Act of 1928, ch. 852, § 12, 45 Stat. 791, 796-97. From 1932 to 1963, there were always at least 24 different income tax brackets. See, e.g., Revenue Act of 1932, ch. 209, § 12, 47 Stat. 169, 174-77; Revenue Act of 1942, ch. 619, § 103, 56 Stat. 798, 802-03. For the year 1964, there were only 13 brackets, Revenue Act of 1964, Pub. L. No. 88-272, § 111, 78 Stat. 19, 19-23, but the number increased in 1965 when there were 25 brackets. From 1965 until 1986, the number of brackets ranged from 12 to 25. The Tax Reform Act of 1986 decreased the brackets to three, Pub. L. No. 99-514, § 101, 100 Stat. 2085, 2096-99, but the Omnibus Budget Reconciliation Act of 1993 increased the number of brackets to five. Pub. L. No. 103-66, § 13201, 107 Stat. 312.

38 For example, under current law, a single taxpayer with $22,100 of wages would be in the 15% bracket. If she incurred a single capital gain of $100,000, the last $7,100 of the gain would be taxed at 36%. IRC § 1(a).
bunching is created by the realization rule. The proper way to account for the gain is to tax it as it accrues (after taking inflation into account).

One might make the case that, once having accepted the realization requirement, it is inappropriate to offset the advantage of deferral against the disadvantage of bunching. Even assuming that bunching is a problem in a second-best world, an averaging provision such as former § 1301,39 or possibly something akin to § 1341(a)(5), would be a superior way to redress bunching.40

A capital gains preference, however, deals very poorly with those few cases in which bunching presents a problem because it is not targeted. It applies in the extreme to cases involving no bunching;41 it offers the same preference to capital assets held for two years as those held for 10 years;42 and it applies to taxpayers whose top marginal bracket remains constant. In most cases, the preference simply compounds the advantage of deferral.43

39 Former §§ 1301-1305 employed an averaging system that allowed taxpayers to elect a tax computation method based on the taxable year and the three preceding years. The averaging mechanism operated with respect to the taxpayer's total taxable income. A taxpayer would elect this method when his income for the year was greater than 140% of the average for the three preceding years. A benefit arose where there was a progressive rate structure and the taxpayer was not in the top marginal tax bracket before including the averagable income. There was no relief where the taxpayer's income in the computation year dropped below the base period average. In other words, there was no retroactive application. See generally Richard Schmalbeck, Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity, 1984 Duke L.J. 509 (1984).

For example, a five-year averaging provision could be adopted for those with unusually high income in any given year. On the facts of our example, T would be treated as if she had $100 of gain in each of the four preceding years, and $100 in the current year. It is hard to justify adopting this type of provision for capital gains and not for other types of income. Cf. IRC §§ 665-668.


41 Where a capital gains preference applies to an asset held more than six months, former IRC § 1222 (before amendment in 1984), taxing the gain on an asset held for more than six months but less than one year presents no bunching question whatsoever.

42 For a short time during the 1930's, a capital gains preference that was more narrowly targeted at bunching was in effect. The Revenue Act of 1934, ch. 277, § 117, 48 Stat. 680, 714 called for decreasingly smaller percentages of capital gains to be included in income as the holding period for the asset increased. The reduction of taxable gain was substantially modified in 1938, Revenue Act of 1938, ch. 289, § 117, 52 Stat. 447, 501, and was repealed in 1942, Revenue Act of 1942, ch. 619, § 150, 56 Stat. 798, 843.

43 To the extent there is any case for a preference as a solution to the bunching problem, Professor Blum overstates it. He concludes "[u]ndoubtedly some preferential treatment of capital gains is fairer than taxing them in full without allowing a spread." Blum, note 2, at 253. It strikes us that so few cases actually present a problem (that is, where bunching is not completely offset by deferral) that overtaxation of those few taxpayers is more than compensated by undertaxation of all the others.
D. Double Taxation of Corporate Earnings

Under our current income tax system, corporate income is taxed twice, once at the corporate level when earned, and again at the shareholder level when distributed. This "classical system" of taxation is inconsistent with an ideal Haig-Simons income tax and has been the subject of much criticism. For decades, reformers have called for its elimination by integrating the corporate and individual income taxes.

Reformers argue that the double taxation of corporate income creates serious inefficiencies. These manifest themselves in less than optimal corporate equity investment because corporations require a higher pretax rate of return than other investors to offset the effects of the tax. Thus, corporations do not invest in certain projects that otherwise would make economic sense. If these projects are so large that as a practical matter they can be undertaken only by corporations, the projects will not be undertaken at all.

Proponents of the preference for capital gains argue that, in the absence of integration, the preference can be justified as a second-best solution to the inefficiencies created by the double taxation of corporate earnings. Although a preference would not completely eliminate the problem created by the classical system, it would reduce its impact. Because this argument for the preference is premised on the inefficiency of the classical system and the concomitant importance of

44 IRC § 11.
45 IRC § 301.

Although corporate stock is the largest component of realized capital gains, it represents only about a quarter of the total. Gravelle & Lindsey, note 5, at 398. If a case could be made for the preferential treatment of stock, it would be a significant, but not conclusive argument.
integration, it is persuasive only to the extent these premises are valid and then only with respect to subchapter C stock. There is, however, no consensus on the degree of inefficiency created by the classical system, nor on the importance of integration as a tax policy goal.

The degree to which the classical system is inefficient depends on the extent to which corporations actually must seek a greater pretax rate of return on their investments than must other entities, or stated somewhat differently, the extent to which corporations have a higher marginal cost of capital than do other entities. The marginal cost of capital to a corporation depends upon its source, of which three are possible: borrowed funds, retained earnings and new issues of equity. Each is discussed directly below.

**Borrowed Funds.** The classical system does not distort investment decisions of a corporation that borrows. Because interest is deductible by the borrowing corporation, interest payments do not bear a corporate tax burden; only a single level of tax is imposed, at the lender's rates. As a lender's rate of return is unaffected by the tax rates of its borrowers, holding risk constant, corporations can borrow on the same terms as other entities. Therefore, double taxation does not create economic distortion when a corporation borrows funds to invest and no inefficiency results.

**Retained Earnings.** Similarly, no (or very little) economic distortion stems from double taxation when a corporation invests its retained earnings, but the reason is not so obvious. It is best understood by exploring the following proposition: There is no economic compulsion for a corporation either to retain its earnings, or to distribute them, *so long as* both the corporation and shareholder have the same after-tax rates of return and the tax imposed on corporate distributions is the same whenever the distribution is made. To examine this proposition, consider the following example:

* X Corporation has $125 of assets, all acquired through retained earnings. All shares of X are owned by A, an individual. Both a corporate income tax and an individual income tax are imposed at a flat rate of 20%. X and A each demand a pretax rate of return of 10% (implying an after-tax rate of return of 8%). There is no tax on corporate distributions or on the sale of stock.

On these facts, A's shares would be worth $125; as long as X and A have the same investment opportunities, A would be indifferent as to whether X makes current distributions. For example, if X retained the

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48 IRC § 163(a).
entire $125, after one year, it would grow to $135 (at an after-tax rate of 8%), which could be distributed to A. Alternatively, $125 could be distributed to A to invest, which (at an after-tax rate of 8%) would grow to $135 in one year.

Assume, alternatively, that without advance warning, a 20% tax is imposed on all corporate distributions, no matter when they occur. A would still be indifferent to X’s decision about distributions. After one year, X’s retained earnings of $125 again would grow to $135, which upon distribution, after paying tax of $27, would leave A with $108. Alternatively, if X distributed $125 today to A, she would pay $25 in taxes, leaving her $100 to invest. This amount invested for one year also would grow to $108.

It is important to note that, with respect to equity “trapped” at the corporate level, the existence of a double tax does not cause any inefficient allocation of resources. The double tax does not require X to seek investments with an expected rate of return any higher than that required by entities that are not subject to a double tax, in this case 10%. Thus, the double tax does not require a corporation to seek a higher pretax rate of return on investments made with retained earnings.

The imposition of this tax on corporate distributions comes at a cost, all of which is borne by the shareholder owning the stock when the tax is imposed. The tax instantly reduces the value of A’s shares to approximately $100; A incurs a loss, reflected in the value of the stock. The cost of the corporate-level tax is capitalized into the price of the shares. If A were to sell the shares, a purchaser would pay no more than $100 because the purchaser would demand an 8% after-tax return on her investment.

Although this abstraction is an oversimplification,49 the basic proposition that the classical system causes little or no distortion with respect to retained earnings probably holds. Indeed, retained earnings may be preferable to borrowed funds. It seems more than likely that corporations have at least as high an after-tax rate of return as their shareholders. Furthermore, although all distributions are not taxed at the same rate,50 this deviation would only encourage corporations to retain earnings rather than to distribute them.

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49 This is because we have assumed that the corporation and its shareholders have the same after-tax rate of return. That may not necessarily be so. First, the corporation may have a higher pretax rate of return because it has different investment opportunities. Second, the individual and corporate tax rates rarely are the same. A corporate rate higher than the individual rate would provide an incentive to distribute.

50 For example, many redemptions are entitled to capital gain treatment, IRC § 302(a), and are subject to a maximum rate of 28%, IRC § 1(h). This creates a bias for corporations to retain earnings, rather than distribute them to shareholders as dividends.
New Issues. Where a corporation raises capital by issuing new stock, however, investors will require the corporation's expected rate of return to be higher than market to offset the effect of double taxation. To illustrate, reconsider the earlier example in which there is a 20% tax rate on both corporate and individual income, including corporate distributions and gains on the sale of stock, and investors require an 8% after-tax rate of return on their investments. Now suppose X needs to raise $100 of new equity capital. If X's pretax rate of return is only 10% (the market rate), investors will not purchase the new issue because it would yield only 6.4% after tax to them: X's after-tax rate of return still would be 8%, but the investors would have to pay an additional tax of 1.6% on distribution, resulting in a 6.4% net shareholder return. Because this return would be unacceptable, X must seek investments that yield a minimum of 12.5%. Therefore, corporations that raise their marginal capital in the equity market must have a higher pretax rate of return than other entities.

In sum, if a corporation uses either borrowed funds or retained earnings to make an investment, the existence of a tax on distributions is irrelevant to the investment decision. That is, no economic distortion is created by two levels of tax. On the other hand, if a corporation raises equity funds through a new issue, the corporate investment must have a higher pretax rate of return than would be required of other entities.

Thus, the source of a corporation's marginal capital is critical to the issue of whether the classical system is inefficient. If the source is borrowed funds or retained earnings, the system is not inefficient, the argument in favor of full integration is weakened, and the related argument favoring a capital gains preference is invalid. If, however, the source of marginal capital is from new issues of equity, the classical system is inefficient and the argument for a capital gains preference for stock as a second-best alternative gains force.

The source of a corporation's marginal capital is inextricably related to a conundrum that has puzzled scholars for years: Why do corporations pay dividends? This is a perplexing question for at least two reasons. First, the tax law always has imposed a tax on a distribution of corporate earnings; second, retained earnings are a ready source of additional equity capital. Nevertheless, historically public companies have distributed approximately 60% of their earnings to their shareholders. There are two competing explanations for this phenome-

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non, commonly referred to as the "traditional" view and the "new" view.\(^5\)

Those who subscribe to the traditional view note that there are extremely powerful market forces—the most important of which is the "signaling" by the corporation of its financial strength and future prospects—that compel the corporation to make a current distribution even though it otherwise might use its retained earnings for capital investment. Such a distribution could increase the corporation's cost of capital substantially and thereby affect its investment decision: A given investment that might be attractive if made from retained earnings, might not be if a new issue were required. Under this view, the distortion created by the classical system can be eliminated fully only by complete integration of the corporate and individual income taxes.

Absent integration, however, a capital gains preference might offer a reasonable second-best solution because it would partially reduce the impact of the classical system. Although there would continue to be a tax on dividend distributions, at least the retained portion of the corporate earnings would bear a lower tax burden. A capital gains preference operates only on the retained portion of corporate profits that is subject to a second level of tax on disposition of the corporate shares. In the case of a corporation that follows the historic distribution/retention pattern, under the traditional view, the tax on corporate source income at the shareholder level is the sum of the tax at ordinary rates on 60% of earnings and the tax at capital gain rates on 40% of earnings.\(^5\) Using this weighted average in the above example, an exclusion of 50% of all capital gains would reduce the tax by 20% at the individual level to 16%.\(^5\) Therefore, \(X\) would find attractive investments with as low a pretax rate of return as 11.9%.\(^5\)

Thus, under the traditional view, the capital gains preference (as historically structured) is a very poor second-best alternative to integration. First, it exacerbates the existing bias of corporations to retain earnings rather than distribute them. Second, the traditional view im-


\(^5\) See note 51.

\(^5\) \((20\% \times 60\%) + (10\% \times 40\%) = 16\%\).

\(^5\) \($11.90 - \$2.38 [\text{corporate taxes (20\% \times $11.90)}] - \$1.52 [\text{shareholder tax (16\% \times $9.52)}] = \$8.00\).
plies that the current definition of capital assets is too broad. This integration rationale supports a preference only for stock in C corporations and no other assets. Third, this argument for a preference logically would require complete exclusion from the tax base of all gains on corporate stock, not just partial exclusion. The result, however, would be taxation of the retained earnings at the corporate rate, whereas most commentators believe that the appropriate rate at which to tax corporate earnings is the individual rate. This aspect of the capital gains preference might make it an unacceptable alternative even to those who hold the traditional view.

The new view results in far less support for integration and virtually no support for the current capital gains preference. Proponents believe that nontax factors do not explain corporate distributions adequately. Since retaining earnings costs so much less than issuing new equity, they do not believe that a corporation in need of additional capital would make distributions; that corporations do make distributions is strong evidence that more than sufficient equity capital already exists in corporate solution. To the extent there is sufficient equity capital in corporate solution, the classical system is not inefficient. Those who hold this view do not see the urgency to integrate

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56 A preference for stock in S corporations is unwarranted because any inefficiency caused by the double tax necessarily does not occur with a pass-through entity subject to tax only at the shareholder level.


59 Those who support the traditional view have challenged the assumption of the new view models that the only means corporations have to distribute funds is a taxable dividend, arguing that share repurchases are an option. See, e.g., John B. Shoven, Alternative Tax Policies to Lower the U.S. Cost of Capital, in Business Taxes, Capital Costs and Competitiveness (1990). The assumption that corporations expect never to have to issue new shares also has been questioned. Zodrow, Dividend Taxation, note 52, at 501.

60 Halperin, note 52, at 647; Zodrow, Dividend Taxation, note 52. Those who hold the traditional view note that in addition to signalling the well-being of the corporation, dividends partially solve the principal/agent problem; that is, that the payout reduces managerial discretion over profits. Critics find that the use of taxable dividends as a signaling device or as a vehicle to reduce managerial discretion is probably overstated. See, e.g., Zodrow, Dividend Taxation, note 52, at 503.

Those who support the new view also challenge the assumption that marginal investments effectively are made with new share issues, as this assumption is counter to recent evidence. See, e.g., Mark Gertler & R. Glenn Hubbard, Taxation, Corporate Capital Structure, and Financial Distress, in 4 Tax Policy and the Economy 43-71 (Lawrence H. Summers ed., 1990).

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our current individual and corporate tax systems and are apt to believe that the benefits of full integration do not outweigh the windfall gains that would result to existing shareholders.\textsuperscript{61} Under the new view, the argument that the classical system does not require a corporation to seek a higher rate of return than other entities is restricted to existing equity trapped in corporate solution and does not apply to new issues. It is clear, however, that there is a bias against new equity issues and that the issuing corporation must seek a higher rate of return than other entities. Therefore, a proponent of the new view might prefer to integrate the corporate and individual tax systems prospectively by eliminating the corporate tax only for new issues.\textsuperscript{62}

Once again, the historical capital gains preference is not a good second-best alternative as it is poorly designed to deal with even the limited inefficiency suggested by the new view. There is no reason to offer a preference for existing equity; therefore, those who hold this view might support, at most, a preference for new issues of stock of C corporations.

In summary, regardless of whether the new or traditional view of dividend taxation is correct, a broad capital gains preference cannot be supported as an alternative to corporate integration. At most, a preference for corporate stock can be justified and even then, it is unclear whether the preference should extend to an old issue.

\textbf{E. Inflation}

One of the principal arguments used to support the preference is that capital gains are largely inflationary.\textsuperscript{63} To that extent, they do not represent economic income and should not be included in a base with Haig-Simons income as the norm. The optimal solution, indexation, is discussed in detail elsewhere,\textsuperscript{64} but the general conclusion appears to be that indexation may be achieved only with distorting simplifications.\textsuperscript{65}

\textsuperscript{61} This windfall results because the double tax is reflected in the price of the shares.

\textsuperscript{62} See ALI Corporate Distribution Project, note 47.

\textsuperscript{63} See, e.g., Blum, note 2, at 225 (argument 19). To the extent a capital asset is debt-financed, inflation may reduce the cost of borrowing if interest rates do not take inflation into account accurately and the entire interest component remains deductible. See Staff of Joint Comm. on Tax'n, 101st Cong., 1st Sess., Tax Treatment of Capital Gains and Losses (1989) [hereinafter Joint Committee Report].


Even proponents of a preference as a substitute for indexation concede that it is a "rough justice" alternative.66 That it would not account accurately for inflation is obvious in that a capital gains exclusion bears no relation either to the actual amount of inflation or the time the asset is held. The preference might be supported if it coincidentally approximated the results of indexing, but, in fact, exclusion of a fixed percentage of the gain almost never will.67 It provides the wrong results for assets held for both short and long periods of time, although for slightly different reasons.68

For assets held for a long period of time, a preference provides the wrong outcome simply because there may be no problem. In most cases, inflation becomes a smaller and smaller percentage of nominal gain and taxation of the inflation component of the gain generally offsets the benefits derived from deferral.69 The advantage of deferral increases over time and ultimately exceeds the disadvantage of taxing inflationary gains.70 If the asset were held long enough, therefore, a preference would not be necessary.71


67 A capital gains exclusion could result in the same effective tax rate as that imposed with indexing only if the percentage of gain representing inflation exactly equaled the exclusion percentage. Leonard Burman & Larry Ozanne, Indexing Capital Gains, in Capital Gains Reader, note 14, at 319.

68 The preference also can be criticized on the ground that it does not go far enough; that is, it adjusts capital gains, but not other types of income, for inflation. Perhaps if it were more accurate, it could be justified as a step in a piecemeal effort to deal with inflation. Currently, there are a number of provisions in the Code that attempt to adjust for inflation. See, e.g., IRC § 1(f) (tax tables); IRC § 29(b)(2) (nonconventional fuel source credit); IRC § 32(i) (earned income credit); IRC § 63(c)(4) (standard deduction); IRC § 88(b)(2) (itemized deductions); IRC § 151(d)(4) (exemption); IRC § 1274A(d)(2) (original issue discount rules). A counter argument, however, is that offsetting inflation in one sector and not another may be worse than taxing nominal gains.


70 Burman & Ozanne, note 67, at 318; see also Joseph Isenbergh, The End of Income Taxation, 45 Tax L. Rev. 283 (1990) (noting that realization requirement offsets inflation, but expressing uncertainty as to which effect predominates); Edward J. McCaffery, The Capital Gains Debate, Take Two: On Indexing and Fairness, 44 Tax Notes 605, 605-06 (July 31, 1989) (arguing that failure to index is not necessarily unfair because of the countervailing failure to tax accrued, but unrealized appreciation).

71 To illustrate, suppose $1$ invests $100$ for 20 years at a nominal annual rate of return of 10%. This rate comprises a 6% real return and 4% inflation. At the end of 20 years, $T$ sells the asset when its nominal value is $672.75. Under current law, $T$ owes tax on her nominal gain of $572.75. At a 33 1/3% tax rate, $T$'s tax is $190.92, leaving net proceeds of $481.83 ($672.75 - $190.92), measured in Year 20 dollars. Compare this to $T$'s outcome under an annual accrual taxation system. Here, the value of $T$'s investment would have grown at an after-tax rate of 4% per year (6% real return - 33 1/3% tax) and, before taking into account inflation, the investment would have been worth $219.11 (measured in Year 1 dollars) at the end of Year 20. Converting this amount into Year 20 dollars to reflect the
For assets held a short time, deferral offers little offset to the inflation component and thus inflation is more of a problem. In some situations, an exclusion may not be sufficient to compensate for the inclusion of inflationary gains in income. For example, where $T$ holds an asset for one year that appreciated in value 10%, of which 6% were attributable to inflation, a 50% exclusion would be insufficient to offset the effects of inflation. For assets held either long-term or short-term, an exclusion is of no use to a taxpayer who experiences an economic loss.

Wholly apart from the advantage of deferral, a fixed percentage exclusion does an extremely poor job of addressing long-term inflation. Even a variable percentage exclusion generally is a reasonably accurate substitute only if the percentage of gain excluded decreases as the asset's holding period increases. Although this point is counterintuitive, it is easy to demonstrate. The table below reflects various characteristics of an asset purchased for $100 that grows in value at a constant nominal rate of 15% per year (10% inflation and 5% real return). If the object of the exclusion is to offset inflation, the correct exclusion ratio is equal to inflation divided by nominal gain. As is shown in the table, this ratio declines over time, because although the unrealized real gains as well as the basis of the asset are subject to inflation, only the latter should be indexed.

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annual 4% inflation, $T$ holds $480.10 in Year 20 dollars after taxes. The benefits of deferral, therefore, have more than offset the disadvantage of not indexing basis.

72 Although never enacted, there have been legislative proposals that would have provided an exclusion that increased with the passage of time. President Bush's budget proposal for the 1993 fiscal year would have allowed a capital gains exclusion where the percentage excluded varied with the holding period. Qualified assets held more than three years would have had a 45% exclusion; assets held more than two years but less than three years would have had a 30% exclusion; and assets held more than one year but less than two years would have had a 15% exclusion. Staff of Joint Comm. on Tax'n, 102d Cong., 2d Sess., Summary of Revenue Proposals in the President's Fiscal Year 1993 Budget 3 (1992). Budget requests for the 1991 and 1992 fiscal years had similar proposals, but with exclusions of 30%, 20%, and 10%, respectively. Staff of Joint Comm. on Tax'n, 102d Cong., 1st Sess., Summary of Revenue Provisions in the President's Fiscal Year 1991 Budget Proposal 3 (1990). See also note 42.


74 The reason that unrealized gain should not be indexed for inflation may be illustrated by the following example: In Year 1, $T$ acquires an asset in which she has a zero basis. The asset appreciates in value and in Year 5, it is worth $500. During this same period of time, there has been 200% inflation. Although a portion of the $500 gain is inflation on unrealized appreciation, because the gain is measured in Year 5 dollars, no inflation adjustment is necessary. Only if the gain were to be measured in Year 1 dollars, would it be appropriate to take inflation into account.
Although it is easy to state that a variable exclusion should decrease with time, it would be quite difficult to design such a preference. The above table assumes a constant rate of inflation and real gain. So long as nominal gain exceeds inflation, any other pattern also would produce a decreasing percentage, but the relationship between each year's exclusion ratio and the next would vary widely depending on the actual inflation and the nominal gain. Therefore, even if the preference were designed as a decreasing exclusion, unless complex annual adjustments were made, it would offer at most very rough justice.

In summary, the historically designed capital gains preference is so rough as to provide no justice; in many cases it would exclude real gain and in almost all cases would account for inflation on a purely random basis. Furthermore, any attempt to design an exclusion that would provide an accurate inflation adjustment is probably doomed to failure.

**F. Risk**

Proponents argue that a preference is necessary to offset the negative effects on risk taking of an income tax, especially one with limitations on the deduction of realized losses. At least as a normative goal, a well-designed tax system should leave the taxpayer free to assume the same amount of risk that he would assume in a tax-free world. Commentators often argue that the mere existence of an income tax discourages risk taking because it reduces the expected return from a risky investment. This reduces economic welfare because investors may shift their portfolios toward less risky assets than they would retain in a nontax world. Proponents of a preference for capital

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75 Burman & Ozanne, note 67, at 319-20.
76 See, e.g., Walker & Bloomfield, note 28, at 1022.
77 Unless a tax expenditure that would affirmatively encourage or discourage risk taking is desired, the system should be neutral as to the assumption of risk.
gains argue that it is an effective way to reduce this distortion. Terms and Conditions
mains the same (2.5 to 1), although the amount of loss to which \( X \) is exposed has changed. Because there is a full loss offset, if \( X \) invests $100 in Investment #2 and it becomes worthless, \( X \) will lose only $40, not $100.\footnote{Because of the full loss offset, the government bears 60\% of any loss from the investment.} For this reason, it is at least plausible (if not likely) that imposition of this tax actually may increase \( X \)'s (and other investors') willingness to invest in risky ventures, not discourage it.\footnote{If \( X \) still is willing to put $100 at risk in Investment #2, the loss offset enables \( X \) to invest $250 without personally losing more than $100 (that is, the value of a $250 loss deduction under this tax is $150).} Thus, investors may choose riskier investments than they otherwise would have.\footnote{Progressivity might discourage risk taking by a low-bracket taxpayer because of its effect on the investor's expected after-tax rate of return. To illustrate, if \( X \) expected to be in the 40\% bracket if Investment #2 became worthless, but in the 60\% bracket if its value increased, \( X \) would stand a 50\% chance of losing $60 (because the value of the loss deduction would only be $40) and a 50\% chance of winning $60. On these assumptions, the expected rate of return to \( X \) would be zero. Although \( X \) would not be likely to make this investment, the effect of progressivity on risk taking is unclear. See Livingston, note 80, at 170 n.22 (discussing economic studies). The current system is far less progressive than it has been historically and for those investors already in the top bracket, it is effectively proportional.} A bias in favor of risk also reduces economic welfare because, by increasing the return from risky assets, it encourages investment in risky investments that would not be undertaken in a nontax world.

The current system differs from the tax imposed in this example in at least two ways that may be significant. First, full loss offsets are not available; there are a host of loss limitations to which a particular investor might be subject.\footnote{See Joseph Bankman & Thomas Griffith, Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?, 47 Tax L. Rev. 377 (1992). Not all economists agree that a tax with full loss offsets actually encourages risk. See, e.g., Martin S. Feldstein, The Effects of Taxation on Risk Taking, 77 J. Pol. Econ. 755, 763-64 (1969); Stiglitz, Effects, note 79, at 274.} Second, the current system is not completely proportional, but rather has a degree of progressivity.\footnote{Progressivity might discourage risk taking by a low-bracket taxpayer because of its effect on the investor's expected after-tax rate of return. To illustrate, if \( X \) expected to be in the 40\% bracket if Investment #2 became worthless, but in the 60\% bracket if its value increased, \( X \) would stand a 50\% chance of losing $60 (because the value of the loss deduction would only be $40) and a 50\% chance of winning $60. On these assumptions, the expected rate of return to \( X \) would be zero. Although \( X \) would not be likely to make this investment, the effect of progressivity on risk taking is unclear. See Livingston, note 80, at 170 n.22 (discussing economic studies). The current system is far less progressive than it has been historically and for those investors already in the top bracket, it is effectively proportional.} Loss limitations are the more important of the two differences. Their application would discourage taxpayers from investing in risky ventures. To illustrate, in the example, if \( X \) could not deduct any portion of her loss, Investment #2 would offer an expected after-tax rate of return of negative 20\% and an expected value of $80.\footnote{There is a 50\% chance that the investment will be worth $160 ($250 less taxes of $90) and a 50\% chance that it will be worth zero; therefore, the investment's expected value is only $80. Since there is a 50\% chance that the investment will increase in value by 60\% and a 50\% chance that it decrease in value by 100\%, the expected rate of return on this investment is -20\% ((60\% - 100\%)/2).} Since \( X \) would expect to lose money in Investment #2, she would not invest in it. Thus, if

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\footnote{See, e.g., IRC §§ 465, 469, 1211.}
losses are restricted, the income tax may be biased against risk. Robert Scarborough argues that it is impossible to design a method of treating losses under a realization-based income tax that is neutral as to risk. Refundable losses would create a bias in favor of risk. Full loss offsets would create a bias in favor of investments subject to unique risk, provided the taxpayer eliminated the risk through diversification. It is not clear whether there would be a bias with regard to positions subject to market risk.\(^8\)

There is some question, however, about how many investors are actually subject to loss limitations. Professor Livingston argues that the current system approaches complete loss offsets, at least in the case of established firms that can offset losses from one venture with the income from another. The same is true for investors who have diversified portfolios\(^9\) and are able to offset capital losses from one stock with gains from another. The loss limitations, however, do impact new companies and some individuals. Professor Livingston posits, however, that overall, the argument that our current system discourages risk taking is clearly overstated.\(^9\) If true, the case for a preference on this ground evaporates.

Assuming arguendo, that loss limitations create an unacceptable bias against risk taking, the problem is most appropriately addressed by modifying these limitations directly.\(^9\) A capital gains preference, however, is a very poor second-best solution.\(^9\) The definition of capital asset is not in any way targeted toward "risky" investments. There is no reason to think that financial investments in stocks and bonds are any riskier than a direct investment in a new business. Indeed, because an investor can diversify, existing financial instruments may

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\(^9\) Not all investors are well diversified in their holdings. Many hold shares in only a few companies.

\(^9\) Livingston, note 80, at 168; see James M. Poterba, Capital Gains Tax Policy Toward Entrepreneurship, 42 Nat'l Tax J. 375, 375-82 (1989) (stating that only a very small amount of capital gains comes from start up business; also, most capital in new companies comes from corporations not entitled to preferential treatment of capital gains).

\(^9\) Obviously, the most direct way to eliminate this bias would be a full offset of capital losses. This solution, however, may have its own set of problems. See Scarborough, note 89 (discussing problems with capital loss limitation and proposing an alternative system). Alternatively, provisions targeted at risk or start up businesses may be more appropriate, see, e.g., IRC §§ 1202, 1244, although Congress has not been particularly effective at defining either type of venture.

\(^9\) Furthermore, as Robert Scarborough points out, there is no reason loss provisions should be designed in the same manner as a capital gains preference. Scarborough, note 89, at 682. Even assuming there is a case to be made for a preference, it undoubtedly should be directed at different assets than would a loss limitation provision.
be among the least risky investments available.\textsuperscript{94} Furthermore, even to the extent the preference actually were aimed at risky investments, it might not remove the bias of the income tax against risk. In the above example, \(X\) would not invest in Investment \#2 if there were a 60\% tax and no loss offset, although he would have absent an income tax. Suppose instead, 60\% of the gain were excluded. \(X\) still would not invest in the risky asset because Investment \#1 would have an after-tax return of 4\%\textsuperscript{95} and Investment \#2 would have an after-tax return of only 2.5\%\textsuperscript{96}

\textbf{G. Lock-In Effect}

\textit{1. The Lock-in Phenomenon}

The most serious argument in favor of a capital gains preference is premised upon the so-called lock-in effect.\textsuperscript{97} The lock-in effect describes an investor's reluctance to incur a tax on realization of gains; it is a direct consequence of prior decisions to impose a realization requirement and not to tax gains at death.\textsuperscript{98} An investor who is not taxed until realization and who can avoid tax altogether by holding an asset until death, tends not to change investments, even though he may believe that higher returns are available elsewhere. For example, suppose \(T\) holds Asset \#1 with a basis of $100 and a value of $500 in a world with a flat 25\% tax on income. The expected yield on this investment is 10\%, or $50. \(T\) has the opportunity to invest in Asset \#2, which has an expected yield of 12\%. If \(T\) sold Asset \#1, he would pay $100 in taxes, leaving only $400 to invest in Asset \#2. Because a $400 investment in Asset \#2 has an expected yield of only $48, \(T\) will not change investments. The toll charge prevents \(T\) from diversifying his portfolio.

Although studies differ as to the extent of realizations, they all agree that a large percentage (approximately one-half) of capital gains are never subject to tax.\textsuperscript{99} This lock-in of accrued gains is said to cre-

\textsuperscript{94} See Livingston, note 80, at 192 (arguing that the type of risk that should be encouraged is systematic risk, not diversifiable risk).

\textsuperscript{95} 10\% return – taxes of 60\% = 4\%.

\textsuperscript{96} If \(X\) invested $100 in Investment \#2, there would be a 50\% chance that \(X\) would have an after-tax profit of $105 ($150 gain less taxes of $45), and a 50\% chance that she would have an after-tax loss of $100. The expected return on the investment would be $2.50 (($105 - $100)/2), or 2.5\%.

\textsuperscript{97} Blum, note 2, at 256-58 (argument 21—a tax on capital gains impairs the mobility of capital).

\textsuperscript{98} See text accompanying notes 4-15.

\textsuperscript{99} See note 12. Of course, there may be reasons other than the tax burden that would prompt a taxpayer to retain an asset with accrued appreciation. For example, the owner's desire to bequeath a closely held business to a child may outweigh the advantage of changing to an investment with a higher rate of return.
ate inefficiency that impedes the flow of capital to its most productive uses. An individual who wishes to diversify her portfolio or to sell to fund consumption may be unwilling to do so, thus reducing her utility. For example, an investor might want to reduce (or increase) the risk in her portfolio or sell stock to buy a home or enjoy other forms of consumption. This alteration of investment decisions is said to misallocate capital, especially in the case of an entrepreneur who might otherwise use capital for a new venture.

Whether the lock-in effect attributable to the tax burden imposes a significant onus on the economy as a whole is less clear. Although an individual may benefit greatly by changing her portfolio, it is not clear that it matters much to society who owns IBM stock. Trading in marketable securities (a significant source of capital gains), for example, has only marginal effects on the economy as a whole and is not likely to increase the total amount of investment. While lock-in discourages some investors from selling stock and investing in venture capital, this is not a common case. If the real objection to lock-in is the difficulty in directing assets to venture capital, the preference should be redefined. Even if lock-in does not significantly burden

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100 Some argue that a capital gains incentive should not be available where the taxpayer sells an investment asset in order to enjoy consumption because the preference is designed to encourage “investment” mobility. Joseph M. Dodge, Restoring Preferential Capital Gains Treatment Under a Flat Rate Income Tax: Panacea or Placebo?, 44 Tax Notes 1133, 1138 (Sept. 4, 1989); Calvin H. Johnson, The Consumption of Capital Gains, 55 Tax Notes 957, 958-61 (May 18, 1992). If, however, lock-in is undesirable because it prevents capital from flowing to its highest and best use, there should be no objection to capital diverted to consumption. The taxpayer must believe that the value of consumption exceeds the value of the investment asset.

101 That is, while there may be an individual welfare loss, it is not clear that there is a general welfare loss. It also is not clear that individuals who engage in tax minimization strategies involving hedging transactions are really locked in. These strategies are described in Scarborough, note 89, at 692-95.

102 Alan J. Auerbach, Retrospective Capital Gains Taxation, 81 Am. Econ. Rev. 167, 167 (1991) [hereinafter Retrospective] (lock-in effect “leads investors to accept a lower before-tax rate of return than they would for new investments without such accrued gains, resulting in a distorted allocation of capital and inefficient portfolio selection”).

103 Even if the preference were redefined, the extent of the impact on the investment in venture capital is uncertain. According to Henry Aaron, only 12% of equity for venture capital is raised from taxable sources, which presumably leaves 88% of such investment unaffected by the preference. Henry J. Aaron, The Capital Gains Tax Cut Mystery, 54 Tax Notes 1269, 1271 (Mar. 9, 1992) (citing James M. Poterba, Venture Capital and Capital Gains Taxation, in 3 Tax Policy and the Economy 47-67 (Lawrence H. Summers ed., 1989)).

“Venture capital” is an oft-used, but seldom-defined term. It usually refers to equity in new or “start-up” companies, see, e.g., Aaron, supra, or small businesses, see, e.g., George F. Break, The Perception of Power: The Capital Gains Story, 52 Tax Notes 229, 229 (July 8, 1991). Occasionally, it is described as the capital provided to “entrepreneurs” (another undefined term). See, e.g., Walker & Bloomfield, note 28, at 1022. A tax preference for small and/or new businesses would necessitate linguistic line drawing that would not place the venture capitalist necessarily on the preferential side of the line.
the economy as a whole, it certainly burdens those holding appreciated assets and those not holding assets at all because they must pay higher taxes than they otherwise would have.

2. **Optimal Solutions to Lock-in**

There is a fairly widespread belief that eliminating tax induced lock-in by treating appreciation and depreciation in the theoretically correct manner is not viable. The lock-in effect would not exist if gains were taxed as they accrued. Thus, adoption of a mark-to-market system would eliminate distortions caused by lock-in. The consensus, however, is that the cost of implementing an accrual system would be so high as to make it infeasible. We disagree. While practical obstacles to an accrual system remain, it is likely that, in the long run, they can be surmounted. In the meantime, a mark-to-market system already exists for assets that can be valued easily and could be applied much more widely. Because the primary obstacle to a mark-

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104 The probable effect of eliminating lock-in would be a swap of investment portfolios. See Goode, note 40, at 205. In a sense, the well-being of the economy is simply the sum of the well-being of its individual members.

105 This point is discussed further in Section III.G.3, but the general notion is that the rate of tax on ordinary income is higher than it would be if accrued capital gains were realized, producing additional tax revenues.

106 Treasury Dep't, Blueprints for Basic Tax Reform 5, 81 (2d ed. 1984) ("The proposal does not recommend taxation of gains as accrued... because the administrative cost of annual asset valuations is prohibitive and because otherwise taxpayers might face problems in making cash tax payments when no cash had been realized."); General Tax Reform: Panel Discussions Before the House Comm. on Ways and Means, 93d Cong., 1st Sess. 285 (1973) (testimony of Professor Richard A. Musgrave) ("Obviously... taxation of all current but unrealized gains on an annual accrual basis would be unmanageable."); Bradford, Personal Consumption Tax, note 27, at 83 ("The difficulty of obtaining annual valuations and the potential cash flow problems for taxpayers with large accrued income but no cash income have generally led to the acceptance... of a realization basis for capital gains accounting."); James W. Wetzler, Capital Gains and Losses [hereinafter Capital Gains], in Comprehensive Income Taxation, 115, 120 (Joseph A. Pechman ed., 1977) [hereinafter Comprehensive Income Taxation] ("completely eliminating deferral means taxing on accrual, which must be ruled out because it would be extraordinarily difficult to value nonmarketable assets every year").


One significant obstacle is the failure to index. Adoption of a mark-to-market system without indexation would result in very high effective tax rates. Currently, deferral offsets the negative effect of inflation. See text accompanying notes 68-71.

108 IRC §§ 1092, 1256.

to-market system is valuation, scholars have proposed a variety of surrogates for accrual taxation\textsuperscript{110} and others could be developed. Alternatively, taxation could be delayed until realization to permit valuation through a market transaction, but only if deferral of the tax liability were compensated by an interest charge (or a credit for deferral of the savings attributable to loss deductions).

Even if accrual taxation on a large scale is impractical, it is still possible to address lock-in by attacking its most significant cause head on: the step up of basis at death.\textsuperscript{112} Whereas the realization requirement offers deferral, § 1014 offers permanent exclusion and, thus, absent accrual taxation, is the root cause of lock-in. Hence, the optimal reform solution is to repeal § 1014. But, then, what should replace it?\textsuperscript{113}

One possibility is carryover basis.\textsuperscript{114} Beneficiaries would assume the decedent’s basis, as donees now do.\textsuperscript{115} This is a terrible response, with both practical and theoretical problems, that not only would prevent effective solution of lock-in, but also would create new distortions. Carryover basis is inherently flawed, in that it would perpetuate the benefit of deferral. Although carryover basis theoretically would eliminate § 1014’s exclusion benefit, it often would have the same practical effect because deferral would be extended indefinitely. At best it could lessen, but not eliminate, the lock-in incentive created by deferral generally. More likely, it might exacerbate lock-in as the gains could increase dramatically as property passes from generation to generation.


\textsuperscript{111} See, e.g., Auerbach, Retrospective, note 102, at 167-69 (proposing a realization-based tax imposing a higher rate on gains held for longer periods of time to mimic an interest-bearing tax deferral regime); Roger Brinner & Alicia Munnell, Taxation of Capital Gains: Inflation and Other Problems, New Eng. Econ. Rev., Sept.-Oct. 1974, at 3; Wetzler, Capital Gains, note 106, at 115-57. For critical reviews of interest-bearing tax deferral proposals, see Cunningham & Schenk, note 110, at 744-46; Alvin C. Warren, Jr., Comments, in Comprehensive Income Taxation, note 106, at 158, 161.

\textsuperscript{112} Although basis can be stepped up or down at death, lock-in generally is caused only by the ability to step up basis because losses on assets usually will be realized before death. Even if they are not, the change in basis at death creates no incentive to retain loss assets.

\textsuperscript{113} Recall that as a design matter, gains and losses would be taxed as they accrue, lock-in would not be a problem and the issue of a preference would not arise. Once the decision has been made to adopt a realization-based income tax, the reform question is how best to counter the resultant lock-in.

\textsuperscript{114} One of the reasons given by Congress for the passage of former § 1023 was lock-in. H.R. Rep. No. 1380, 94th Cong., 2d Sess. 37 (1976), reprinted in 1976-3 C.B. (vol. 3) 735.\textsuperscript{115} IRC § 1015.
The practical problems with carryover basis are well known. The history of former § 1023 is an unfortunate fiasco that points—as often occurs in tax reform matters—to transitional problems as the tail that wags the dog. Even if the transitional rules could be simplified, the additional costs, the failure to generate revenue at death and the possible increased lock-in effect combine to make carryover basis the least desirable alternative.

A superior alternative would treat death as a realization event. First widely discussed more than 30 years ago, proposals to tax gains at death continue to draw support, and no effective criticism has emerged. Critics assert that appreciation would be twice taxed, assuming continuance of the estate tax. This is not a significant criticism because this "double" taxation applies to all after-tax wealth not consumed before death. Even so, others have proposed elimination of the estate tax as the quid pro quo for income taxation at death. The complexity and administrative burdens, largely at-

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118 Logically, losses should be deductible at death as well. An unlimited deduction for capital losses has its own problems, however. See Scarborough, note 89, at 697-99.


120 That such a tax would be levied on the inflationary component of the gain is a valid criticism, but is not limited to gains taxed at death. The proper approach would be to tax the indexed gain.


122 See Jerome Kurtz & Stanley S. Surrey, Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal, 70 Colum. L. Rev. 1365, 1386 (1970). Because estate tax rates were established under the assumption that gains were not realized at death, it might be appropriate to revisit the rates. Professors Kurtz and Surrey also effectively dismiss other, even more frivolous arguments. Id. at 1386-89.

123 See, e.g., Galvin, note 119, at 1415. Professor Galvin proposes eliminating the estate tax and replacing the revenue with an income tax on gains and losses recognized at the time of transfer, either death or gift. He asserts that this system would be more efficient and equitable than the present transfer tax system because it would require accounting for income earned during life. For criticism of Professor Galvin's proposal, see Robert B. Smith, Burying the Estate Tax Without Resurrecting Its Problems, 55 Tax Notes 1799, 1801-04 (June 29, 1992) (arguing that valuation and liquidity problems would remain and loss recognition would invite manipulation); see Charles O. Galvin, Burying the Estate Tax: Keeping Ghouls Out of the Cemetery: A Reply to Professor Smith, 56 Tax Notes 951, 951-53 (Aug. 17, 1992) (responding that the proposals would work better or at least as well as the present system).
tributable to the need for valuation or appraisals, are probably over-stated, but in any event, are no worse than the transactional complexity engendered by current law. The most significant issue is liquidity, a stumbling block for any proposal curtailing the realization requirement. But there are ways to address illiquidity that economically eliminate the advantage of deferral while preserving illiquid assets. While liquidity may be a political problem, it is not a theoretical flaw and is not such a sufficient criticism that taxation at death should founder.

A final potential reform proposal to eliminate lock-in is a rollover provision for reinvestment of the proceeds on disposition of a capital asset. Gain would be deferred until cash was extracted for consumption, provided proceeds were reinvested in an eligible replacement asset. While a rollover provision would decrease lock-in and

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124 Michael J. Graetz, Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals, 59 Va. L. Rev. 830, 838 (1973) (stating that while some proposals are "unduly complex," requiring additional recordkeeping, correspondence and contests, fine tuning might eliminate problems); Kurtz & Surrey, note 122, at 1393-94 (capital gains taxation at death is no more complex than existing law).

Because valuation currently is required to establish basis under § 1014, realization at death would not increase valuation burdens. Furthermore, valuation of the decedent's property already is necessary for estate tax purposes, either for the federal tax or for the much more commonly imposed state inheritance or succession tax. As with § 1015, it may be impossible in some circumstances to ascertain a decedent's basis because of poor recordkeeping. This problem can be solved by repealing § 1014 and imposing death realization only for assets acquired after the date of enactment that have a § 1012 cost basis in the decedent's hands. Although this would permit all existing appreciation to escape tax, that is no worse than the forgiveness that § 1014 now extends.

125 See text accompanying notes 158-74.


127 See Cunningham & Schenk, note 110, at 743-46.


129 The attention paid to the complaints of closely held businesses and farmers cannot be overstated.

130 See Kurtz & Surrey, note 122, at 1396-1400 (noting that illiquidity could be solved by extensions of time for payment and that farms, in any event, should be converted to more productive use if they are not sufficiently profitable to ever pay the tax); Zelenak, note 119, at 437 (noting that the problem is no different than it is for estate tax currently). As Professors Kurtz and Surrey point out, the burden at death is heavy only because the burden during life has been light. Kurtz & Surrey, note 122, at 1397.

eliminate liquidity problems associated with an accrual tax, it is not the optimal solution for an income tax. Assuming it were combined with constructive realization at death, rollover effectively would provide the equivalent of consumption tax treatment of capital assets, which clearly is inappropriate if income is the normative tax base.

In summary, we do not find the obstacles to adopting the theoretically correct treatment (accrual) or an acceptable surrogate (taxation of gains at death) so formidable as to compel reliance on a second-best approach. Indeed, if we were designing a tax system based upon a Haig-Simons definition of income, we would never seriously consider a preference for capital gain because lock-in would not be an issue. A tax base that distinguished receipts based on source would result in inefficiencies and inequities. Nevertheless, we are not designing an ideal tax and must consider second-best solutions, such as a capital gains preference. The remainder of this Section considers how the efficiency and equity aspects of the preference should be framed and evaluated in the context of a reform proposal to eliminate lock-in.

3. Capital Gains Preference as a Second-Best Solution

a. Efficiency

i. Would a Cut Raise Revenue?

There is general agreement that a preference for capital gains would ameliorate the lock-in problem, and would result in increased realizations. The extent of the increase is controversial. Because the lock-in effect presents the strongest argument favoring a preference, it is important to try to determine the relationship between tax rates and realizations. In large part, a capital gains preference as a second-best solution to lock-in appears attractive because it actually might produce additional revenue from increased realizations. We next briefly

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132 If not, lock-in would be decreased, but it would not be eliminated. The incentive to hold assets until death would remain, especially as the taxpayer ages.

133 A rollover provision would not provide consumption tax treatment for all assets, since most proposals would apply only to capital assets. See Blum, Rollover, note 131, at 400; Goode, note 40, at 206-08.

134 See Gerard M. Brannon, The Lock-in Problem for Capital Gains: An Analysis of the 1970-71 Experience 27 (1974); Gravelle & Lindsay, note 5, at 401-03; Johnson, note 100, at 958; Donald W. Kiefer, Lock-In Effect Within a Simple Model of Corporate Stock Trading, 43 Nat'l Tax J. 75, 75-76 (1990). But see Thomas F. Field, Aaron and Bloomfield Square Off at Session on Capital Gains Book, 54 Tax Notes 361, 361 (Jan. 27, 1992) (comment by Henry Aaron noting that failure to tax appreciation at death will limit amount of increased realizations); Popkin, note 34, at 162 (explaining why capital gains preference is a poor response to the lock-in problem). Congress generally has accepted the argument that high rates reduced the revenue derived from capital gains. See, e.g., S. Rep. No. 1631, 77th Cong., 2d Sess. 49-50 (1942).
discuss this possibility, without attempting to resolve the controversy. Rather, we undertake to discuss the issue in terms that lawyers can understand and to search for common ground of agreement. Simultaneous reduction of lock-in and significant revenue production would present a powerful case for the preference as a reform measure. The subsequent Section evaluates that case.

The starting point of the argument is the well-accepted notion that taxes affect behavior. Any tax, except a head tax, imposed on any item or activity, prompts taxpayers to investigate alternatives or substitutes to avoid the tax. As the tax rate increases, the avoidance incentive also increases. It long has been recognized that there is a revenue maximizing rate for most taxes, a point at which, if the tax rate were increased, the tax would generate less revenue than if it were left unchanged. Revenues would decline because taxpayers would engage in less of the activity or would find alternative ways to conduct it so as to avoid the tax.

The revenue maximizing rate for any tax is a function of many factors, the most important of which is how easy it is for taxpayers to avoid it.135 The revenue maximizing rate declines with the ease of avoidance. Under current law, the tax on capital gains is remarkably easy to avoid. Avoidance can be accomplished, first, by simply holding the asset, since the tax is imposed only upon a sale or exchange. Second, a taxpayer can realize the value of an asset without incurring the toll charge by resorting to nonrecognition provisions, such as §§ 1031, 1034 and 368, or borrowing, using the asset as security.136 Finally, and most important, taxpayers can avoid the tax altogether simply by holding the asset until death.137 Furthermore, absent loss limitations, individuals who wished to minimize tax would engage in a strategy of acquiring offsetting positions in risky assets and subsequently realizing the losses and deferring the gains.138 These factors imply low capital gains realizations.139

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136 See Floyd Norris, For Wall St., a New Tax Break, N.Y. Times, Mar. 29, 1994, at D1 (describing an equity swap that permits executives to enjoy capital appreciation without paying tax).
137 IRC § 1014; see also IRC § 121 (permanently excluding $125,000 gain on the sale of a principal residence once the taxpayer has reached the age of 55).
138 See Scarborough, note 89, at 685-86.
139 Empirical work indicates, however, that while a tax minimizing strategy theoretically may be desirable, a relatively low percentage of individuals may actually pursue such arbitrage opportunities. See, e.g., James M. Poterba, How Burdensome Are Capital Gains Taxes? Evidence from the United States, 33 J. Pub. Econ. 157 (1987) (finding low use of tax minimization strategies); H. Nejat Seyhun & Douglas J. Skinner, How Do Taxes Affect Investors' Stock-Market Realizations? Evidence from Tax-Return Panel Data (University
Because the tax is often avoidable, it is not surprising that taxpayers are sensitive to rates. The only question is how sensitive. Economists measure this sensitivity by the "realizations elasticity," which is defined as the percentage change in realizations (measured in dollars) divided by the percentage decrease in the tax rate. An elasticity of one (in absolute values) implies no change in revenue. If the elasticity is more than one, a tax reduction produces additional revenue; if less than one, a tax reduction loses revenue. As the realizations elasticity varies with the tax rate, it is important to know the tax rate for which a given elasticity is determined. For example, if the realizations elasticity were determined to be 1.2 with respect to a 22% rate, then a reduction in the rate below 22% would increase revenue. The assumption is that elasticity increases as tax rates increase. At low rates, a tax increase has little effect on realizations and revenues would rise; thus, there would be an elasticity of less than one. At a higher rate, the tax exerts a stronger effect. A rate increase will cause realizations to decline by a percentage exceeding that of the rate increase; the elasticity would be greater than one. At this point, revenues fall and a revenue-maximizing rate is reached.

The actual realizations elasticity (and its implicit revenue maximizing rate) obviously is very important for political, economic and fiscal reasons. As a result, extensive empirical research over the last 15 years has sought its value. Nevertheless, nothing close to a consensus has emerged. Of Michigan Working Paper, 1991) (finding that only 5% to 7% of investors use tax minimization strategies and 90% usually follow a buy and hold strategy).

This is a simple statement of a very complex relationship. Although the relationship, as stated, often holds, it is actually dependent on a number of factors such as the correlation between average and marginal tax rates on capital gains, the degree of progressivity, an individual's realizations tax elasticity and other simultaneous changes in the tax structure that would affect behavior. Thus, a reliance on the simple relationship may be somewhat misleading. See Zodrow, Economic Analyses, note 36, at 437.


In measuring the realizations elasticity, economists have used three different types of empirical studies: cross section, panel series, and time series studies. Each has its limitations. Cross section studies use data from many individual tax returns from a single year. These studies have tended to find relatively high elasticities, which implies a fairly low revenue-maximizing rate. These studies have been criticized because they cannot take into account the transitory effects. Panel studies also use cross sectional data, but follow taxpayers for a period of years, usually two or three years. They have been criticized for failing to account fully for transitory effects and for failing to measure individual specific effects. Time series studies use data relating to many years, for aggregates of taxpayers rather than specific individuals. These studies almost always have lower elasticities than cross-sectional studies. Time series studies also have been subject to criticism because they do not capture certain variables other than tax rates that influence realizations and thus they probably overstate elasticity. Economists do not agree on which type of analysis is best for determining the relationship between realizations and tax rates. For an exhaustive

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sus has developed. Researchers do not even agree on a theoretical model of capital gains realization behavior, which is the cornerstone for most empirical work.\textsuperscript{143} All studies appear to suffer from theoretical problems, such as how to account for feedback effects (for example, a portfolio reallocation from less-favored ordinary income assets to tax-favored capital gains),\textsuperscript{144} expectations of future tax rates\textsuperscript{145} and various econometric issues,\textsuperscript{146} as well as practical problems such as the absence of reliable data. Although all studies have found realizations responsive to capital gains rates, to date the models have produced wildly inconsistent elasticities ranging from 0.5 to more than 3.\textsuperscript{147}

Despite the chaotic state of the empirical evidence, most research indicates that the revenue maximizing rate for capital gains is likely to be less than the ordinary income rate, although even this is not entirely free from doubt.\textsuperscript{148} Despite political and fiscal importance, the actual revenue maximizing rate is not essential to evaluate the preference as a reform measure. While it is clear that the conclusions drawn from the econometric work are quite tenuous, the issue that we, as lawyers, wish to pursue is the policy implications if the empirical work ultimately coalesced on a realizations elasticity that implied a revenue maximizing capital gains rate less than the ordinary rate.

\textit{ii. Implications for Capital Gains Preference}

Although the principal reason for our income tax is to raise revenue, revenue production alone does not justify a particular provision. That is, simply because taxing capital gains more favorably than ordinary income would raise additional revenue does not of itself justify the preference. Like other commentators, we agree that revenue should be raised in as fair and efficient manner as possible.\textsuperscript{149} Therefore, even if a preference for capital gains raised revenue, we would evaluate the preference on efficiency and equity grounds.

The relevant issues raised by this inquiry are crystallized by consideration of two alternate proposals that raise precisely the same reve-
nue. Assume that all income is taxed currently at 28%, regardless of source, but that, for whatever reason, additional revenue must be raised. Which of the following two proposals represents better tax policy, assuming the evaluative criteria are efficiency and equity?

* No Preference Proposal: Raise the top tax rates on all income to 42%, regardless of source.

* Preference Proposal: Leave the top rate on capital gains at 28% and raise the top rate on all other income to 40%.

In examining the efficiency of each proposal, it is useful to distinguish between tax burden and taxes paid. Assuming the revenue maximizing rate for capital gains were 28%, as the capital gains rate rose beyond 28%, the burden of the tax would increase, although the total revenues would decline. The difference between the burden imposed and revenue raised is the excess burden, or the deadweight loss of the tax. This burden can be regarded as the lost opportunities that those with capital gains have forgone. The larger the excess burden, the less efficient the tax, as it represents a decline in social welfare not gained by the government in the form of revenue. It is important to note that, as the rates increase from 28% to 42% in this example, the burden of the tax on holders of capital assets would go up substantially, while, at the same time, the amount of taxes they actually pay would go down considerably. That they would pay far less in taxes does not mean they are better off; it simply means that, at the proposed 42% rate, the lock-in effect would be so great that realizations would decrease substantially compared to their level at a 28% rate.

When asked to evaluate whether one proposal is better than another, economists and social choice theorists often resort to the Pareto efficiency standard. Under this standard, a given allocation of resources is said to be Pareto efficient if the only way to make one individual better off is to make another individual worse off. A reallocation of resources is a Pareto improvement if it makes at least one person better off without making anyone worse off. This reallocation may be Pareto optimal if there is no other alternative that everyone will regard as at least as good, and at least one person will regard as better. It is implicit in this approach that society generally would

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150 We assume that the revenue maximizing rate is 28% solely for purposes of illustrating this discussion and not because we are certain that studies fixing the rate at 28% are accurate.


favor a Pareto efficient allocation of resources and would support any Pareto improvement.\footnote{To determine whether a particular proposal is a Pareto improvement, it is necessary to determine the relevant population. Consider, for example, a proposal to eliminate trash from Washington Square Park. See Noël B. Cunningham & Deborah H. Schenk, How to Tax the House that Jack Built, 43 Tax L. Rev. 447, 485 n.154 (1988) (arguing it would not be from a squirrel's point of view).}

Using this standard, the Preference Proposal is undoubtedly a Pareto improvement over the No Preference Proposal and probably is Pareto optimal. At least initially, the Preference Proposal appears to be a Pareto improvement because by its adoption, everyone is better off financially than they would be under the No Preference Proposal.\footnote{See David F. Bradford, Untangling the Income Tax 149 (1986) [hereinafter Untangling].} Capitalists (that is, those with capital gains) clearly would be better off, for they would be taxed at a lower rate (that is, 28\%) under the Preference Proposal. Although, as a class, they would pay more taxes, they would benefit from the reduced tax burden on their property. Laborers (that is, those who do not hold capital gains) would be better off because they, too, would pay a lower rate (that is, 40\%) under the Preference Proposal. Finally, the government would be no worse off because it would raise an identical amount of revenue.

The Preference Proposal also appears to be Pareto optimal, because assuming location of the revenue maximizing rate and taxation of capital gains at that rate, no other proposal would make anyone better off without making someone worse off. Assuming the revenue maximizing rate on capital gains is 28\%, the rate cannot be reduced without raising the rates on other income; on the other hand, the rate of tax on other income cannot be reduced because the tax on capital gains already is set at the revenue maximizing rate.

The No Preference Proposal, however, is not a Pareto improvement and thus does not efficiently allocate resources. Capitalists would be worse off, despite paying less taxes, because the tax would impose a higher burden on their property, prompting fewer realizations. This increased burden would not translate into increased revenues; rather, it would be a deadweight loss. Laborers also would be worse off because their tax burden would increase from 40\% to 42\%.

The assumption in this analysis is that everyone would prefer the Preference Proposal because they are financially "better off."\footnote{Professor Sen refers to a proposal as being Pareto superior "where someone prefers \( x \) to \( y \) and everyone regards \( x \) to be at least as good as \( y \)." Id. at 24. In fact, he goes on to say that "[i]f \( x \) is Pareto-superior to \( y \) . . . it will be difficult to argue that \( x \) should not be socially preferred to \( y \)." Id. This argument assumes that a capital gains preference is pegged at the revenue-maximizing rate. As explained earlier, there is no consensus on the actual rate. See text accompanying notes 134-48. If Congress were to set the rate at the wrong level, a preference would}
that not the case, the Preference Proposal might not be a Pareto improvement.\textsuperscript{157}

This analysis is flawed in one respect.\textsuperscript{158} In determining whether the taxpayer is financially better off under either alternative, the analysis thus far looked only to the taxes paid under each proposal. This ignores possible indirect costs associated with either proposal that may place the taxpayer in a less advantageous financial position than initially appears. Specifically, a focus simply on the tax burden may ignore the enormous complexity created by the rate differential.\textsuperscript{159} This complexity has costs that may affect the financial positions of laborers and capitalists alike and thus must be weighed in evaluating the efficiency gains of the preference proposal.

A capital gains preference creates several types of complexity\textsuperscript{160} that appear to be universally disdained.\textsuperscript{161} First, rule complexity increases; because the preferential rates apply only to certain categories

\textsuperscript{157} An additional benefit of the Preference Proposal is that it would not increase the lock-in effect. The No Preference Proposal, conversely, would increase it dramatically. As noted above, everything else being equal, increasing the lock-in effect decreases the mobility of capital and prevents it from going to its highest and best use.

\textsuperscript{158} We consider the efficiency gains of a capital gains preference without regard to other government regulation that might affect realizations and thus admittedly might affect the efficiency gains. See George Mundstock, Taxation of Business Intangible Capital, 135 U. Pa. L. Rev. 1179, 1183 n.14 (1987) ("there is no reason, per se, to believe that a slight reduction in the tax system's effect on behavior will increase efficiency. Other tax provisions or governmental regulations may have so changed the economy from what it would be in the absence of governmental modification that an additional modification from a tax provision might countermand some other efficiency-reducing effect of government or otherwise increase economic efficiency."); Scarborough, note 89, at 679 n.9 ("It is possible that biases introduced by nonneutral tax rules may offset biases introduced by other government action.").

\textsuperscript{159} Although improving efficiency or equity does not necessarily breed complexity, it is clear that the Preference Proposal (like that of current law) would result in additional complexity that would pose a potential trade-off. For a rejection of the general applicability of a complexity/efficiency or complexity/equity trade-off, see Edward J. McCaffery, The Holy Grail of Tax Simplification, 1990 Wis. L. Rev. 1267, 1279-87 [hereinafter Simplification].

On the other hand, a preference proposal could be structured without much particularization. For example, since many capital gains realizations involve stock, see note 47, and a case can be made for a preference for new issues in the absence of integration, see Section III.E, a fairly simple preference proposal involving new issues of C corporation stock could be drafted. A broad-based preference aimed at ameliorating lock-in, however, necessarily would be more complex.

\textsuperscript{160} For general discussions of the various types of complexity, see Bradford, Untangling, note 155, at 266-67; McCaffery, Simplification, note 159, at 1270-72.

\textsuperscript{161} See, e.g., Bradford, Untangling, note 155, at 47 ("One can hardly exaggerate the contribution to the complexity of the income tax of present rules for the taxation of capital gains."); see also Impact, Effectiveness, and Fairness of the Tax Reform Act of 1986: Hearings Before the House Comm. on Ways & Means, 101st Cong., 2d Sess. 174 (1990) (state-
of income, congressional line drawing is essential.\textsuperscript{162} A substantial effort by the Service and the private sector to learn and interpret the rules usually follows.\textsuperscript{163} When rate differentials are meaningful, there is an increased likelihood of disputes over various eligibility requirements, often resulting in litigation and a secondary body of case law.\textsuperscript{164} Second, transactional complexity of a significant magnitude arises.\textsuperscript{165} Because the tax treatment is often contingent on the structure of a transaction, a staggering amount of time is devoted to converting ordinary income into capital gains.\textsuperscript{166} Everyday transactions thus become more complex, time-consuming and expensive as lawyers and accountants rearrange the transactions to obtain the benefit of the preference.\textsuperscript{167} This has several negative effects. First, it is not a productive use of time or resources. Second, it could result in inefficient structures, created solely to obtain tax benefits, and may inhibit otherwise desirable structures or transactions. Third, at the margin, it breeds uncertainty. Finally, so long as the preference is not universal-

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\textsuperscript{162} See Peter H. Schuck, Legal Complexity: Some Causes, Consequences, and Cures, 42 Duke L.J. 1, 18-22 (1992) (detailing the transaction costs of legal complexity including the difficulty of lawmakers in agreeing on a formulation and the difficulty of reform).

\textsuperscript{163} There are a significant number of Code provisions that would have no or diminished importance in the absence of a capital gains preference. See, e.g., IRC §§ 64, 302, 306, 341, 355, 724, 735, 751, 1201, 1202, 1211, 1212, 1221, 1222, 1223, 1231, 1233, 1234, 1234A, 1235, 1236, 1237, 1239, 1241, 1242, 1243, 1244, 1245, 1246, 1247, 1250, 1252, 1253, 1254, 1256, 1257, 1258, 1271.

\textsuperscript{164} See Joint Committee Report, note 63, at 7-11 (noting litigation involving holding period, sale or exchange treatment, asset allocation and other issues resulting in a significant body of law).

\textsuperscript{165} Professor McCaffery describes this kind of complexity as “dynamic complexity” attributable largely to the fact that complexity breeds further complexity. He gives the spiraling complexity resulting from the capital gains preference as an example. McCaffery, Simplification, note 159, at 1276.

\textsuperscript{166} Bradford, Untangling, note 155, at 273 (“It is sometimes said that one-half of the practice of a tax lawyer is finding ways to convert ordinary income into long-term capital gains, the other half being the conversion of long-term capital losses into ordinary [losses].”); Comm. on Personal Income Tax, Ass’n of the Bar of the City of New York, Report on Proposed Capital Gains Tax Rate Reduction, 90 TNT 202-12, Oct. 2, 1990, available in LEXIS, Fedtax Library, TNT File [hereinafter City Bar Report] (“taxpayers will inevitably attempt to recharacterize transactions that would otherwise produce ordinary income so as to achieve capital gain treatment”). The reintroduction of conversion efforts revitalizes Code sections designed to limit such techniques. See, e.g., IRC §§ 341, 751(b), 1258.

\textsuperscript{167} The City Bar Report, note 166, provides the following illustrative list of transactions that become more complex: allocation of purchase price, sales of property, dispositions involving recapture, disposition of assets produced by personal effort, deferred payments based on productivity, partnership allocations and timing of sales due to holding period rules.
sally applied to capital, funds will not flow necessarily to their most productive uses.\(^{168}\)

Although there seems to be almost universal agreement that the capital gains rules account for a significant portion of the Code's complexity,\(^ {169}\) there does not appear to have been any serious attempt to quantify this cost. This, however, is essential if the efficiency aspects of the preference are to be evaluated. The issue is whether all of the efficiency gains from taxing capital gains at a lower rate than ordinary income are offset by the complexity losses.\(^ {170}\) Our sense is that it has not been weighed heavily enough, if at all.\(^ {171}\) If the complexity losses are large enough and therefore the efficiency gains are small enough, any equity argument assumes far more importance.

It is possible changes in the structural design of the preference could reduce complexity losses, especially those stemming from rule complexity.\(^ {172}\) This might decrease the efficiency loss due to complexity. But there is a serious question whether any amount of statutory fine tuning would result in sufficient simplification to eliminate these indirect costs. Furthermore, a decline in precision actually might decrease compliance and increase administrative costs.\(^ {173}\)

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\(^{168}\) Alan Auerbach has noted that models that evaluate efficiency effects without taking into account arbitrage encouraged by a capital gains preference, are likely to misstate the benefits. Alan J. Auerbach, Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric, 2 Brookings Papers on Economic Activity 595-631 (1988). Even ignoring the complexity costs, such activity may result in lower revenues as capital moves to tax-favored capital assets.

\(^{169}\) See note 161.

\(^{170}\) If even one person would prefer the No Preference Proposal because the complexity costs are such that he is better off without the preference (or for any other reason), the Preference Proposal is not a Pareto improvement. That does not alone mean, however, that society may not choose the Preference Proposal. The Pareto criterion is incomplete. See Sen, note 153, at 22.

\(^{171}\) Cf. J. Gregory Ballentine, Tax Policy and Revenue Sufficiency in the 1980's, in Personal Saving, Consumption, and Tax Policy 34, 37 (Marvin H. Kosters ed., 1992); McCaffery, Simplification, note 159, at 1297 (noting that cost of tax advice and preparation can be considered dead weight losses and that there are also opportunity costs in the time, energy and intellect devoted to tax planning); Shaviro, Selective Limitations, note 18, at 1223-24.

Although some work has been done to quantify compliance costs, see, e.g., Joel Slemrod, The Return to Tax Simplification: An Econometric Analysis, 17 Pub. Fin. Q. 3, 23-25 (1989) (attempt to predict probable resource cost savings from tax simplification), such costs generally are not considered an offset to efficiency. Cf. Alan A. Tait, Not So General Equilibrium and Not So Optimal Taxation, 44 Pub. Fin. 169, 177-79 (1989) (positing that costs and inequities of administering real taxes in the real world may overwhelm value of various models).

\(^{172}\) See, e.g., Calvin H. Johnson, Seventeen Culls from Capital Gains, 48 Tax Notes 1285 (Sept. 3, 1990). Congress has not had much luck with clearly delineating the line between capital gains and ordinary income and a case can be made that the failure to do so offsets any other justification for the Preference Proposal.

On one level, complexity may not be a concern because a taxpayer who chooses to sell presumably has determined that the benefit from the sale (for example, the opportunity to diversify his portfolio or to obtain a higher return) outweighs the toll charge and the complexity. We are uncertain, however, whether this calculation accounts for all complexity costs, either to the selling taxpayer or to other taxpayers. Both may incur financial and time costs in considering whether to purchase (or sell) capital assets and may devote considerable unsuccessful effort to restructuring transactions to take advantage of the preference. In addition, the detail added to forms and instructions that nonholders of capital assets are forced to confront even if they never contemplate acquiring a capital asset is not reflected in the above calculus. Thus, some taxpayers may bear a cost without any welfare gain.

Thus, from an efficiency perspective, the choice between the two proposals is clouded by the lack of empirical work on the complexity costs of the preference. Nevertheless, it seems likely that the Preference Proposal is efficient (in terms of being a Pareto improvement). In order to explore equity as an independent standard and its relationship to efficiency, we assume in the next Section, that the Preference Proposal is efficient. That is, even considering the complexity costs, we assume for the sake of argument that everyone is better off under the Preference Proposal than under the No Preference Proposal.

b. Equity

Opponents of a capital gains preference traditionally attack it on the ground that it is inequitable. The thrust of the argument is that, in the Haig-Simons formulation of income, source is irrelevant and "a dollar of capital gain is like any other dollar of economic gain." We do not think this to be so simple a proposition and find that it needs some explication.

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174 See Schmalbeck, Uneasy Case, note 3, at 201 (shocking levels of inefficiency make a strong prima facie case for reducing capital gains rates).

175 See, e.g., Dodge, note 100, at 1138-39 (arguing that the preference is perverse because it is unfair to provide a taxpayer who has taken advantage of the realization requirement an incentive to sell); Daniel I. Halperin, Why Not the Best? Retain Equal Treatment of Capital and Ordinary Income, 48 Tax Notes 368, 368-69 (July 16, 1990) [hereinafter Equal Treatment] (arguing in part that one should not worry about the welfare loss to those who have the political muscle to retain current distortions).

176 Blum, note 2, at 261 (argument 1); see also William D. Andrews, Personal Deductions in an Ideal Income Tax, 86 Harv. L. Rev. 309, 316-17 n.12, 375-76 (1972).

177 See Blum, note 2, at 261 ("It stands by itself and requires no exposition. It asserts a simple proposition."). See also Richard A. Musgrave, Horizontal Equity: A Further Note, 1 Fla. Tax Rev. 354, 359 (1993) [hereinafter Further Note]. In discussing the 1986 Act, he noted: "changes such as the more equal treatment of capital gains ... were seen as remov-
An initial inquiry is why if the Preference Proposal were actually efficient (that is, a Pareto improvement), we would want to evaluate it using an additional standard. The simple answer is that we may not want a Pareto optimal economy.\textsuperscript{178} Professor Sen gives the example of such an economy in which "some people are rolling in luxury and others are near starvation" but "the starvers cannot be made better off without cutting into the pleasures of the rich."\textsuperscript{179} Although it may be difficult to develop a criterion that should override Pareto optimality in all, some or even this case, the weakness of the Pareto efficiency standard\textsuperscript{180} makes the pursuit worthwhile. In fact, although not essential to this debate, we always would weigh equity even if the efficiency gains, by any standard, were clear.

Most commonly, the criterion that is given some or equal weight is "fairness." While the literature has paid increased attention to what is meant by fairness,\textsuperscript{181} scholars have devoted very little discussion to the relative weight to be given to fairness and, when it conflicts with efficiency, which factor controls.\textsuperscript{182}

\textsuperscript{178} Because the Pareto standard often is unable to rank various tax proposals, commentators occasionally use the Kaldor-Hicks standard, under which a proposal is judged efficient if those who benefit hypothetically could compensate those who do not and still be better off. J.R. Hicks, The Valuation of Social Income, 7 Econ. 111 (1940); Nicholas Kaldor, Welfare Propositions of Economics and Interpersonal Comparisons of Utility, 49 Econ. J. 549 (1939); see also Jules L. Coleman, Efficiency, Utility, and Wealth Maximization, 8 Hofstra L. Rev. 509, 513-14 (1980) (description of Kaldor-Hicks standard). Any proposal that is Pareto optimal also satisfies the Kaldor-Hicks standard because the absence of losers does not require the hypothetical compensation. Because we judge the Preference Proposal to be a Pareto improvement compared to the No Preference Proposal, and thus efficient, it is unnecessary to consider the Kaldor-Hicks standard.

\textsuperscript{179} Sen, note 153, at 22.

\textsuperscript{180} See, e.g., id. ("a society or an economy can be Pareto-optimal and still be perfectly disgusting"); Rosen, note 152, at 52 ("Pareto efficiency has no obvious claim as an ethical norm. Society may prefer another, inefficient, allocation on the basis of equity, justice, or some other criterion."); see also, Richard A. Musgrave & Peggy B. Musgrave, Public Finance: Theory and Practice 284 (5th ed. 1989) ("Minimizing total deadweight loss, therefore, is not the only relevant consideration."); C. Edwin Baker, The Ideology of the Economic Analysis of Law, 5 Phil. & Pub. Aff. 3, 27-41 (1975) (asserting that the values promoted by efficiency are inadequate); Martin J. McMahon, Jr., Individual Tax Reform for Fairness and Simplicity: Let Economic Growth fend for Itself, 50 Wash. & Lee L. Rev. 459, 469 (1993) ("economic efficiency is not inherently an all encompassing goal"); Richard A. Musgrave, Progressivity Reconsidered, 92 TNT 190-27, Sept. 9, 1992, available in LEXIS, Fedtax Library, TNT File [hereinafter Progressivity Reconsidered] ("The choice among equity norms, in the end, is rooted in considerations of distributive justice, and not to be deduced from Pareto optimality conditions.").


\textsuperscript{182} Although almost everyone would agree that fairness (usually labeled equity) should be considered, the weight it is to be given ranges from conclusive to slight. Compare Dodge, note 100, at 1136 (statement of presumption) and Mundstock, note 158, at 1182 ("An inequitable tax provision is objectionable per se.") with Rosen, note 152, at 52 ("The
In evaluating the equity of a particular proposal, commentators usually speak of both horizontal and vertical equity. The horizontal equity constraint usually is framed as the equal treatment of equals.\footnote{See, e.g., Richard A. Musgrave, The Theory of Public Finance, A Study in Public Economy 160 (1959) ("people in equal positions should be treated equally"); Anthony B. Atkinson & Joseph E. Stiglitz, Lectures on Public Economics 353 (1980) ("those who are in all relevant senses identical should be treated identically").} In an income tax, horizontal equity is said to require that those with equal incomes bear equal tax burdens.\footnote{See, e.g., Martin Feldstein, On the Theory of Tax Reform, 6 J. Pub. Econ. 77, 95 (1976) [hereinafter Tax Reform] ("if two individuals would have the same utility level if the tax remained unchanged, they should also have the same utility level if the tax is changed"); see also Feldstein, Compensation, note 17, at 124. Feldstein distinguishes tax design from tax reform. He asserts that there is never a horizontal equity question in the former assuming equal tastes and a single source of income. Thus, horizontal inequities arise from tax reform. The two proposals considered here present a tax reform question, rather than tax design question. We are asking whether moving from one set of taxes on labor and capital to another violates horizontal equity, rather than whether moving from no taxes to a particular set of taxes would result in an unequal treatment of equals.}

Before proceeding with our evaluation of equity, it is necessary first to review briefly a recent debate in which the concept of horizontal equity as a norm with independent significance has come under challenge. This challenge has been prompted by a series of indices, developed by economists, that measure changes in distribution that would result from various tax reform proposals.

Professor Louis Kaplow has attempted to debunk the apparently widely held notion that horizontal equity has independent significance.\footnote{Louis Kaplow, Horizontal Equity: Measures in Search of a Principle, 42 Nat'l Tax J. 139 (1989) [hereinafter Measures]. He further defends his view in Louis Kaplow, A Note on Horizontal Equity, 1 Fla. Tax Rev. 191 (1992) [hereinafter Note]; see also Thomas D. Griffith, Should "Tax Norms" be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries, 1993 Wis. L. Rev. 1115, 1155-59 (arguing that horizontal equity cannot provide the answer to any important tax policy question).} On one level, Kaplow's complaint is with the various horizontal indices devised by economists. He complains that they fail to measure variations in purported inequality adequately and that all "disruption[s] in the pre-reform distribution of income"\footnote{Kaplow, Measures, note 185, at 143.} are treated as violations of horizontal equity. Kaplow claims the "central defining characteristic" of horizontal equity to be that it "condemns moving individuals closer together in the income distribution."\footnote{Id.} He posits...
that these indices of horizontal equity result in opposition to enhanced equality rather than merely support for its preservation.\textsuperscript{188}

On a second, and much more fundamental level, Professor Kaplow attacks the use of horizontal equity as a tax policy tool because it lacks a normative underpinning,\textsuperscript{189} or more specifically, because those who use it do so without specifying why the status quo distribution of income is to be accorded normative significance.\textsuperscript{190} In stating his objection, he encapsulates the issue posed by our two proposals: "the question is whether one should object to \textit{prima facie} reasonable tax reforms, motivated by concerns of efficiency or distribution, because of the incidental, inevitable, and often unavoidable effects of such reforms on the pre-reform distribution of income."\textsuperscript{191}

Suppose a tax provision were denounced as inequitable because it treated the laborer with $50,000 of wages differently from a capitalist with $50,000 of capital gains. Professor Kaplow argues that there must be a justification for the importance of maintaining post-tax the ex ante equal distribution of income between $A$ and $B$.\textsuperscript{192} Thus, he concludes, absent a justification, the sacrifice of some degree of efficiency to preserve the status quo distribution of income absolutely is difficult to support.\textsuperscript{193}

\textsuperscript{188} We need not be concerned with this criticism because our base inquiry deals with a simpler proposition: Whether a proposal that results in two pre-reform equals being made unequal post-reform is inequitable. The capital gains dilemma could, however, be stated in terms that would raise the criticism levied by Professor Kaplow. Suppose $A$ has $50,000$ of wages and $B$ has $20,000$ of capital gains. The Preference Proposal might be said to provide enhanced equality, as the disparity between $A$'s and $B$'s income would be reduced. $A$ would have $30,000$ of after-tax income [$50,000 - ($50,000 \times 40\%)$] and $B$ would have $14,440$ of after-tax income [$20,000 - ($20,000 \times 28\%)$]. We do not pursue further whether the Preference Proposal, as applied to this example, is inequitable, because if a reform that would not provide equal treatment of equals is tolerable, it is unlikely that there would be concern with a variation that enhanced equality.

\textsuperscript{189} Kaplow, Measures, note 185; see also Thomas D. Griffith, Theories of Personal Deductions in Income Tax, 40 Hastings L.J. 343, 345 ("satisfactory tax policy must make its underlying ethical assumptions and distributional goals explicit").

\textsuperscript{190} Kaplow, Measures, note 185, at 146; Louis Kaplow, An Economic Analysis of Legal Transitions, 99 Harv. L. Rev. 509, 581 n.212 (1986) [hereinafter Transitions] ("concept of horizontal equity can be seen as an a priori (unsupported) bias in favor of the status quo, in that it is commonly understood to demand that the relative position of individuals before a reform is enacted be maintained afterward"). Perhaps Professor Kaplow would support the use of horizontal equity as a tool to attack distinctions based on source. He appears to be concerned about recent uses of the device that do not "present arbitrary distinctions in sources or uses of income when defining a tax base." Kaplow, Measures, note 185, at 139. That is clearly the case with a capital gains preference.

\textsuperscript{191} Kaplow, Measures, note 185, at 139.

\textsuperscript{192} That, of course, is not the only possible goal. As Professor Kaplow points out, another possibility is economic mobility, a target inconsistent with horizontal equity with its insistence on maintaining prereform equality. Id. at 141-42.

\textsuperscript{193} Kaplow, Note, note 185, at 191.
Professor Kaplow argues further that there is no such justification independent of the vertical equity norm. In simple terms, once one establishes the appropriate differentiation of unequals (vertical equity), the appropriate treatment of equals follows automatically.

Professor Richard Musgrave has attempted to provide a justification by showing that under various formulations of distributive justice—Lockean entitlement, utilitarianism and a Rawlsian fairness solution—horizontal equity is required. Professor Kaplow notes, most importantly for the capital gains dilemma, that Professor Musgrave fails to offer an example violating horizontal equity that "any relevant distributive theory would count as decisive against an otherwise desirable policy." Musgrave appears to stand by his earlier exposition, arguing that the proposition that equals should be treated equally is supported by many theories of distributive justice and that what is really needed is a "meta principle," or a means by which vertical equity and horizontal equity can be weighed against each other in considering a particular reform.

We would agree that a theory of distributive justice, on which an equity principle is based, is necessary in order to have a meaningful standard against which to evaluate any proposal. One's preferred theory of distributive justice is reflected in the notion of vertical equity. If we impose a tax that comports with our notion of vertical equity, it necessarily follows that equals will be treated equally. The converse, however, is not necessarily true. For example, suppose economic income is chosen as the base. Just because we tax all those with the same economic income similarly does not mean that the tax is in accord with our concept of vertical equity. To illustrate, suppose all people with incomes of $100,000 or less were taxed at a 50% rate, and all those with incomes of more than $100,000 were not taxed at all. All equals would be taxed equally. Nevertheless, it is hard to imagine a theory of distributive justice that would support this distribution of the tax burden. Thus, horizontal equity is not an independent norm, but rather a corollary of vertical equity.

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195 Kaplow, Note, note 185, at 192.

196 Musgrave, Further Note, note 177, at 358-59.

197 See McDaniel & Repetti, note 194, at 611 (stating that vertical equity also is derivative and has no normative content absent some theory of distributive justice). We also agree that horizontal equity is required only when there is no legitimate basis for inequality. See Kaplow, Measures, note 185, at 149 ("After all, HE demands equal treatment only when there is no legitimate basis for inequality.").
Simply to say, however, that horizontal equity is a corollary of vertical equity is not to say that it does not have a role. In our view, horizontal equity is the means by which we determine the identity of equals. We do so by choosing the tax base, which defines both equals and unequals so that the tax burden can be distributed appropriately. For example, if we choose Haig-Simons income as the tax base, it follows that all individuals with the same Haig-Simons income would bear the same tax burden and those with different Haig-Simons income would be treated differently, in accordance with our notions of a preferred theory of distributive justice.

Thus, the first step in providing an equitable tax system is to define the tax base: How do we determine that two people are alike? Most commentators believe that the base should reflect relative ability to pay. The two most commonly offered bases are income and consumption. Our somewhat tentative view is that economic income is a good yardstick against which to rank individuals. Income best measures ability to pay and thus one's capacity to contribute to the collective welfare. Thus, those with unequal incomes should bear unequal tax burdens (because they have unequal ability to pay) and a fortiori, those with equal incomes should bear equal burdens. While the choice between economic income and consumption is a close one (and other standards such as wealth are less attractive), we proceed using income as the standard for the simple reason that the case for a capital gains preference need not be pursued if consumption is the criterion, and it is important, given the durability of the preference in our current “income” tax, to evaluate the arguments seriously.

The second step, given Haig-Simons income as the tax base, is the determination of whether a particular proposal to reform the base enhances equity. If a particular proposal would enhance equity, but be inefficient (or vice versa), the final step is to balance these two competing considerations. The following two Sections explore these two issues. The first applies the traditional method of determining

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198 This is a question of larger and historical significance. The notion that equals should be treated equally dates to Plato and Aristotle. Aristotle, Ethica Nocomachea V.3.113a-1131b (W. Ross trans., 1925) ("things that are alike should be treated alike"). Both philosophers and legal scholars have devoted much attention to defining “alikeness,” which requires a determination that people are alike in a meaningful regard. See Peter Westen, The Empty Idea of Equality, 95 Harv. L. Rev. 537, 542-48 (1982). Like Professor Kaplow, Professor Westen argues more generally that equality is an empty concept because it is circular. Id. at 547 ("to say that people who are morally alike in a certain respect 'should be treated alike' means that they should be treated in accord with the moral rule by which they are determined to be alike.").

199 Bradford, Untangling, note 155, at 150-51.

200 For a discussion of the arguments in favor of these choices, see Barbara H. Fried, Fairness and the Consumption Tax, 44 Stan. L. Rev. 961 (1992).
whether a proposal promotes equity to the capital gains preference and then weighs that standard against efficiency. The succeeding Section offers an alternative for assessing the impact on equality.

i. Efficiency and the Classic Definition of Equality

The classic formulation of horizontal equity is the proposition that those with equal incomes should be treated equally, that is, bear equal tax burdens. The operative question in evaluating a reform proposal is whether it moves the system closer to that standard. This requires a comparison of the tax burden in the absence of the reform proposal with the burden when the reform is in place.

Even in the absence of a preference, because of the realization requirement, capital gains receive favored treatment. The No Preference Proposal would not eliminate this treatment, but it would not exacerbate it. Furthermore, by raising the tax on all income, no matter what its source, all taxpayers would bear approximately the same burden on their income. Although the burden on capital gains might not translate into additional federal revenue, it nevertheless burdens the income in a similar manner as the tax on labor income. Therefore, the No Preference Proposal would not be rejected as inequitable under the classic formulation.

On the contrary, the Preference Proposal, by reducing the tax burden on already favored income, a fortiori would be inequitable. Increasing the tax on labor income to 40% without increasing the tax on capital income would result in a burden on labor income exceeding that on capital income. If, however, the tax preference were com-

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201 This standard has been formulated in a variety of ways. See, e.g., Staff of Joint Comm. on Tax’n, 99th Cong., 1st Sess., Tax Reform Proposals: Rate Structure and Other Individual Income Tax Issues 2 (1985) (“Horizontal equity requires that taxpayers with equal abilities to pay taxes (i.e., those who have equal incomes) should pay equal amounts of tax.”); H.R. Doc. No. 523, 80th Cong., 2d Sess. 1-2 (1947) (“it is important that like incomes bear like burdens”); Bankman, note 29, at 41 (“Horizontal equity is generally thought to require that taxpayers with equal economic income before imposition of a tax have equal economic income after imposition of the tax.”); Fried, note 200, at 967 (“identically situated taxpayers should be subject to an identical tax”); Kaplow, Transitions, note 190, at 580 (“‘similarly situated’ taxpayers should pay similar amounts of tax”); Marjorie E. Kornhauser, The Constitutional Meaning of Income and the Income Taxation of Gifts, 25 Conn. L. Rev. 1, 26 (1992) (“people with similar incomes ought to pay a similar tax”); Simons, note 4, at 30 (“tax burdens should bear similarly upon persons whom we regard as in substantially similar circumstances”).

202 On the other hand, a preference proposal that increased the burden should not be rejected as inequitable. Suppose, for example, in a world in which capital gains are entitled to a 50% exclusion, the proposal is to reduce the exclusion to 30%. Even if the equity standard were that equals should bear equal tax burdens, we would not object, even though taxpayers with equal income—capital and wages—were not treated equally. Because it would enhance equality, the proposal should not be objectionable as a reform simply because it fails to achieve complete equality.
pletely capitalized into the price of capital assets, no horizontal inequity would result, even under the classic formulation.\textsuperscript{203} We note that this is consistent with a view that a statutorily created unequal treatment of income from capital raises no substantial question of horizontal inequity.\textsuperscript{204} Because the capital markets are thought to be quite efficient, whatever inequalities are created will be short-lived, and the after-tax yields will converge. Thus, for example, an exemption from tax on the yield of one type of capital will cause its yield to fall until it is equal with the after-tax yield on capital not eligible for the preference. The favored asset is said to bear an implicit tax and therefore has an equal tax burden.\textsuperscript{205} Therefore, although nominally unequal treatment of capital income might be inefficient, it is not inequitable, at least among the holders of capital. Thus, a proposal to provide preferential treatment for some kinds of capital but not others does not raise a substantial question of horizontal equity.\textsuperscript{206}

Assuming the preference is not completely capitalized, the Preference Proposal would violate the classic formulation of horizontal equity. Should it be rejected automatically? We think not. This requires a balancing of equity and efficiency. In general, there is no consensus as to which consideration should control.\textsuperscript{207} Perhaps one

\textsuperscript{203} See Boris I. Bittker, Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?, in The Economics of Taxation 19 (Henry J. Aaron & Michael J. Boskin eds., 1980).

\textsuperscript{204} For an exposition of this point, see id; see also Martin J. Bailey, Progressivity and Investment Yields under U.S. Income Taxation, 82 J. Pol. Econ. 1157, 1174 (1974) ("Apparent horizontal inequities as a rule shake out in competitive resource allocation and translate into misuse of resources."). But see Mundstock, note 158, at 1204-05 (suggesting that a tax preference for one form of capital, but not another, violates horizontal equity).

\textsuperscript{205} For a discussion of the capitalization of tax benefits and its relationship to horizontal equity, see Bittker, note 203; see also Bankman, note 29, at 44; Marvin Chirelstein, Federal Income Taxation 361-67 (7th ed. 1994); David J. Shakow, Confronting the Problem of Tax Arbitrage, 43 Tax L. Rev. 1, 2-4 (1987); Alvin C. Warren, Jr., Accelerated Capital Recovery, Debt, and Tax Arbitrage, 38 Tax Law. 549, 559-60 (1985).

\textsuperscript{206} To the extent the tax benefit is not completely capitalized, there would be inequity. See Bankman, note 29, at 44 (suggesting that process of capitalization may not be perfect and to the extent it is not, horizontal equity may be an issue); C. Eugene Steuerle, Taxes, Loans, and Inflation 57-93 (1985) (partial capitalization of financial investments due to existence of low bracket institutional investors).

\textsuperscript{207} There is no general agreement as to whether efficiency or equity should take priority in taxation or in other areas. Some scholars imply that there can never be a conflict between efficiency and equity. See, e.g., Louis Kaplow, The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums, 79 Cal. L. Rev. 1485, 1493 n.37 (1991) (suggesting that horizontal equity does not conflict with the Pareto principle); McDaniel & Repetti, note 194, at 612 ("[horizontal equity] never will prevail to prevent enactment of a provision that would otherwise be appropriate on grounds of administrative efficiency"). Some do not balance the goals. See, e.g., Guido Calabresi, First Party, Third Party, and Product Liability Systems: Can Economic Analysis of Law Tell Us Anything about Them?, 69 Iowa L. Rev. 833, 842-50 (1984).
reason for the limited discussion of a potential trade off between equity and efficiency is that those who analyze tax proposals using the Haig-Simons model of equitable taxation are using an approach that does not integrate efficiency and that appears to assume the primacy of equity. On the other hand, equality is not a concern to optimal tax theorists who view the opportunity to discriminate among taxpayers to eliminate deadweight losses as key. Because we reject the apparent absolutism of both equitable taxation and optimal taxation, the efficiency gains of the preference proposal must be weighed against the equity loss as both standards are deemed relevant.

Others have suggested that considerations of justice would trump efficiency in some circumstances. See, e.g., Developments in the Law, Toxic Waste Litigation: II. Background and Theory of Hazardous Waste Control, 99 Harv. L. Rev. 1465, 1479 (1986) (suggesting that fairness and efficiency are not always "wholly compatible ends" but implying fairness may sometimes be preferable); Kaplow, Transitions, note 190, at 580 n.211 (stating that horizontal equity often is invoked in a manner suggesting that it should weigh heavily against actions that otherwise might be justified on grounds of efficiency); Howard A. Latin, Problem-Solving Behavior and Theories of Tort Liability, 73 Cal. L. Rev. 677, 690 n.71 (1985) (stating some degree of net social efficiency should be sacrificed to prevent unfair distributional consequences where social maximizing choice would make disadvantaged groups worse off); Stephen D. Sugarman, Doing Away with Tort Law, 73 Cal. L. Rev. 555, 603-09 (1985) (implying that principle of horizontal equity should take precedence over goal of efficiency).

Others imply that equity would triumph in most circumstances. See, e.g., Report of the Royal Commission on Taxation 4 (1966) (Carter Commission) ("We are convinced that scrupulous fairness in taxation must override all other objectives where there is a conflict among objectives."); Richard A. Westin, When One-Eyed Accountants are Kings: A Primer on Microeconomics, Income Taxes, and the Shibboleth of Efficiency, 69 Minn. L. Rev. 1099, 1109 (1985) ("Equity considerations are important and should not take a back seat to the relatively unimportant characteristic of efficiency.").

Joseph Stiglitz has suggested that prohibiting unequal treatment might limit arbitrary discrimination by government institutions that do not promote social welfare. Joseph Stiglitz, Utilitarianism and Horizontal Equity: The Case for Random Taxation, 18 J. Pub. Econ. 1, 29 (1982). That rationale seems inapplicable to our example because the unequal treatment clearly results in greater social welfare.

Professor Shaviro has explored the tradeoff between equity and efficiency usefully in the context of the capitalization of preferences. He comes to no general conclusion about the weight to be accorded each, although he does discuss the reasons why one might prefer equity to efficiency. See Shaviro, Selective Limitations, note 18, at 1224-30. For a general discussion on the trade-off between equality and efficiency, see Arthur M. Okun, Further Thoughts on Equality and Efficiency, in Income Redistribution (C. Campbell ed., 1977).


Id. at 429 ("An efficient tax system, whatever its tilt between rich and poor, cannot overlook opportunities to discriminate among taxpayers on the basis of their ability to avoid taxation, even if they should have identical pre-tax incomes."). Professor Musgrave also notes that equitable taxation has been "preoccupied with horizontal equity at the cost of neglecting efficiency," while optimal taxation has been "concerned primarily with efficiency while neglecting horizontal equity." Richard A. Musgrave, ET, OT and SBT, 6 J. Pub. Econ. 3, 14 (1976) [hereinafter ET].
If the efficiency gains were marginal,\textsuperscript{210} we would permit equity to trump for two reasons. First, adoption of the Preference Proposal might decrease the pressure to get the system right. Recall that this analysis is based on a second-best approach and that in all cases we prefer the first-best alternative. If very little advantage is to be gained from the second-best approach, it should be rejected.

Another reason that the equity standard might be permitted to trump a somewhat uncertain efficiency gain with regard to the Preference Proposal is what we call perceptional equity. By that we mean that a proposal probably should be rejected if it is perceived as inequitable.\textsuperscript{211} An initial question is why perceptional equity is important or even relevant. At one level, it provides a useful consideration in balancing equity and efficiency. Where a proposal is both efficient and inequitable (as the capital gains preference may be if the classic definition of horizontal equity is used), the interest in equity may be undercut if the violation of horizontal equity is not seen as inequitable. Conversely, an equitable proposal (for example, a preference for only certain forms of capital\textsuperscript{212}) may be less desirable if it is nevertheless perceived as inequitable.

At another level, a tax that is perceived to be inequitable may be difficult or impossible to administer. Perceived inequity may lead to diminished compliance\textsuperscript{213} and increase the likelihood of outright cheating. This, in turn, will decrease efficiency gains.

\textsuperscript{210} We presume that this quantification would include losses due to complexity. Although we do not know how to measure this, as previously noted, the simplification benefits might offset the revenue gains completely. In that case, there would be no efficiency gain and the Preference Proposal would be rejected.

\textsuperscript{211} See James W. Wetzler, The Role of Fairness in State Tax Policy, 47 Record of the Ass'n of the Bar of the City of New York 38, 39 (1992) (“Fairness is a question largely of perception: a tax system is fair when taxpayers believe that their tax burdens are not out of line with their situations and to burdens imposed on other taxpayers.”); see also Bankman, note 29, at 47 (discussing fairness in terms of appearance); Edward J. McCaffery, Capital Gains: What's the Point, and Are We Missing It?, 43 Tax Notes 223 (Apr. 10, 1989) (suggesting that even if a cut in the capital gains rate increased revenue, it might not be desirable because of psychic value costs); Charles E. McLure, Jr., Comments, in Do Taxes Matter? 332, 333 (Joel Slemrod ed., 1992) (“perceptions of inequity are undesirable in a democratic society in which the tax system is based on voluntary compliance . . . perhaps the perception of fairness should be elevated to equal status with the traditional goals”); Musgrave, Further Note, note 177, at 359 (relying on “the public's sense of equity”).

\textsuperscript{212} See text accompanying notes 203-06.

\textsuperscript{213} See Staff of Joint Comm. on Tax’n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 at 210 (Comm. Print 1987) (“Extensive shelter activity contributed to public concerns that the tax system was unfair, and to the belief that tax is paid only by the naive and unsophisticated. This, in turn . . . undermined compliance.”); Treasury I, note 46, at 13-17; Stanley A. Koppelman, Tax Arbitrage and the Interest Deduction, 61 S. Cal. L. Rev. 1146, 1203 (1988) (“the mere appearance of tax avoidance by the wealthy would adversely affect tax compliance”); Mundstock, note 158, at 1182-83 (inequitable tax provision may damage taxpayers' perceptions of the tax and lead to noncompliance).
Perceptual equity cuts both ways with regard to the two capital gains proposals. The result with respect to horizontal equity is somewhat counterintuitive. If asked to choose, many taxpayers, including those with no capital income, would undoubtedly vote for the Preference Proposal. Colloquially speaking, they probably would not deem as "fairer" a proposal that raised rates for everyone in order to preserve the abstraction that source is irrelevant.\textsuperscript{214} Although a preference undoubtedly would make the owners of capital assets better off (because the tax burden on their holdings would be significantly less), they actually would pay more in taxes, and at a higher effective rate. Nevertheless, because the reduced burden on their holdings benefits labor income as well, allowing the rates to be lower than they otherwise would be, both wage earners and capitalists may perceive the Preference Proposal to be fairer. Alternatively, they may simply prefer the trade-off believing the price of equity to be too high. Some may even find it implausible that a distaste for inequality would trump welfare gains.\textsuperscript{215}

On the other hand, some taxpayers with a strong taste for egalitarianism might reject the Preference Proposal notwithstanding that it benefits them individually or might in the future. Others may perceive the Preference Proposal as unfair because of its distributional effects. Capitalists tend to be in the upper income classes.\textsuperscript{216} A preference that can be described as permitting millionaires to pay tax at a 28\% rate, while requiring wage earners to pay tax at a 40\% rate may be widely viewed as unfair.\textsuperscript{217}


\textsuperscript{214} An apt analogy is suggested by Bradford, Untangling, note 155, at 151: "Two men are crossing the desert on a camel. They have enough water to keep just two of the three of them alive for the full crossing, which cannot be completed on (human) foot. Following the prescription of horizontal equity would require each man to sacrifice the same amount of water to keep the camel going. The result would be that only the camel survives the trip."  \textsuperscript{215} See, e.g., Kaplow, Measures, note 185, at 150 n.2 ("It seems implausible that the slightest inequality in treatment of status quo equals would be thought more important than even substantial gains in overall welfare levels (including to the individuals treated unequally) and significant improvements in equality or other objectives.").

\textsuperscript{216} See note 36.  
\textsuperscript{217} This seems somewhat improbable. Given the recent support for a preference from both Democrats and Republicans, it is not clear that the average person thinks that a capital gains preference is unfair. See Teresa Tritch, Twelve Smart Ways to Stay Ahead of the Feds, Money Magazine, Jan. 1993, at 76 (two-thirds of respondents favored a capital gains rate cut); Adam Clymer, Public Likes Tax Cut but Not Motive, N.Y. Times, Mar. 3, 1992, at D1 (poll found that 44\% favored a cut in capital gains rate while 41\% were opposed); Barbara Rudolph, A Quick Fix Is Not Enough: Tax Cuts May Produce a Spark, but the Economy Needs Long-Term Fuel. Why Not a New Deal for the 90’s?, Time, Jan. 13, 1992, at 39 (cut in tax on capital gains endorsed by 55\% of those polled).
In addition, the extraordinary complexity endemic to the Preference Proposal may increase the perception that it is unfair. A law that is unduly complex will not be understood, and uncertainty, and perhaps even resentment, may follow.\textsuperscript{218} If, to obtain benefits, it is necessary to consult the small group of high priests who alone can divine the law's true meaning in order to obtain its benefits, that costly requirement may augment the judgment that the law is unfair. Finally, if much of the population considers the Preference Proposal inequitable, decreased compliance might impose a high cost on the system as a whole, thus substantially diminishing efficiency (and revenue) gains.

In summary, given the uncertain effects of complexity costs on efficiency gains and a violation of the classic equity standard that compares ex ante and ex post tax burdens, the case for the preference as a solution to lock-in may be unconvincing, even as a second-best solution.

\textit{ii. Efficiency and a Reformulated Determination of Equality}

In designing an income tax, once a base has been chosen and a rate structure imposed, it follows that equals will be treated equally. Evaluating a reform proposal, however, is much more complex. We find the utility of horizontal equity is, at best, marginal and its use actually may produce inequitable results.\textsuperscript{219} By definition, a reform proposal

\textsuperscript{218} See Schuck, note 162, at 22. Although not speaking directly of the Code, Professor Schuck's description of "delegitimation costs" seems particularly apt for the tax law:

When rules are indeterminate, their precise meanings cannot be easily grasped, nor can their applications be readily predicted. Confusion and uncertainty follow. If the rules are technical they will often be opaque to the common mind, common sense, common experience, and even common morality. Intelligible only to the experts, the law is likely to mystify and alienate lay citizens whose intelligence it often seems designed to mock.

Id. at 22-23 (footnotes omitted).

\textsuperscript{219} Others have suggested that the classical approach is not appropriate. Professor Shaviro notes that a literalistic approach would compare actual taxes paid in relation to pretax income, ignoring the tax system's indirect effects. Shaviro, Selective Limitations, note 18, at 1220-21. He suggests that the more theoretically sound, but definitionally and practically infirm approach, would be to compare taxpayers whose incomes would be equal if the tax system did not exist. Id. at 1221. See also Daniel N. Shaviro, Commentary, Uneasiness and Capital Gains, 48 Tax L. Rev. 393 (1993) (suggesting that a determination of equality would take into account benefits received from the government as well as taxes paid). Although we concur that ideally equality (meaning the appropriate distribution of the tax burden) should be judged by netting benefits and burdens, we think such an approach totally unfeasible: We do not think the failure to judge equality in an ideal manner makes the application of equity principles to the income tax meaningless. On the contrary, for the vast majority of taxpayers, the immeasurable benefits will be roughly equal and thus, can be ignored.

Professor Musgrave has offered a similar interpretation of horizontal equity as a way to harmonize efficiency and equity. He suggests that the interpretation of equality should
arises only in the context of a tax system that is "wrong," that is, a system that has at least one deviation from the ideal base and in which taxpayers are bearing inappropriate burdens. In reforming an imperfect system, "fixing" one of the imperfections does not necessarily result in an improvement and may actually increase inequity.\textsuperscript{220}

A proposal that attempts to equalize the tax burden on those with equal incomes\textsuperscript{221} might be undesirable if it fails to treat all equals equally. For example, a reform proposal to tax scholarships could be justified under the classical horizontal equity standard because it would treat a student who receives a scholarship the same as another student at the same school who did not receive a scholarship and paid her tuition through part-time employment. Although these two individuals would bear equal tax burdens, we are not convinced this reform proposal is equitable so long as students at public schools are permitted to exclude the value of their free education from income.

Even a reform proposal that would treat all equals equally might be undesirable. Consider the following example: Assume that using the appropriate standard of distributive justice, the tax burden under an income tax should be allocated in descending order as follows:  \(A\) and \(B\) (equal incomes) followed by \(C, D\) and \(E\). In fact, the actual burden is distributed in the following descending order: \(A, C, D, E\) and \(B\). The reform proposal is to reduce the tax on \(A\) so that \(A\) and \(B\) are treated equally. Although this reform would result in "horizontal equity," it also would result in \(A\) and \(B\) being taxed in a way diametrically opposed to the standard of distributive justice. Whereas they should bear the highest tax burden, they both would bear the lowest.

We reject the proposition that a reform proposal should be either accepted or rejected as equitable solely depending on whether it would result in the equal treatment of equals. Rather, the essential question is whether the distribution of the tax burden after the reform would be more in accord with how the tax burden would be distributed under an ideal tax. A reform measure that moved the tax burden closer to the ideal distribution would enhance equity (even though it did not result in vertical equity).

\textsuperscript{220} Lipsey & Lancaster, note 3.
\textsuperscript{221} Implicit in this formulation is a normative principle that those with equal Haig-Simons income should be taxed equally. Our assumption is that Haig-Simons income reflects the appropriate distribution of the tax burden, that is, it reflects our theory of distributive justice. Obviously, we have reached this judgement antecedent to determining whether two individuals are equal. See note 200. Of course, if we chose some other theory of distributive justice, we would have a different result. If the basis for comparison were consumption, two individuals might be deemed equal even though one had capital gains and one did not.
This approach, while conceptually preferable, is admittedly harder to apply. It does not have the simplicity of the classic definition of horizontal equity that apparently would support any reform proposal that resulted in the equal treatment of equals and would reject any proposal that resulted in the unequal treatment of equals. Whether equals would bear equal tax burdens is only one factor to be weighed in evaluating the equity of a reform proposal because getting one person in the right position does not necessarily enhance equity. The key factor is the relative burdens post-reform. Whether they are closer to the ideal burdens is a question of judgment (or even perhaps aesthetics).

In making this judgment, a relevant factor is the effective rate of taxes paid, both before and after the reform. More specifically, a reform proposal that reduced the disparity between the effective rate of tax and the nominal statutory rate would be strong (although not conclusive) evidence that the proposal would move the system closer to the ideal. Note that this approach does not evaluate the reform solely on the basis of tax burden, instead suggesting that effective tax rates are relevant. But it does not suggest that reducing the disparity between effective tax rates and nominal rates is always equitable. It also does not require the equal treatment of equals.

An evaluation of the Preference Proposal is an example where our approach to equity might result in a quite different judgment than the classical approach. The Preference Proposal would increase the disparity of tax burdens and thus would not result in equal tax burdens on taxpayers with equal income. It therefore would violate the traditional horizontal equity standard. We would not reject the Preference Proposal on equity grounds, however, solely because it did not result in equal tax burdens.

The reduced burden on capital income is one that restricts the choices of those holding capital assets without generating any revenue or benefitting anyone else, either directly or indirectly. Because, however, the Preference Proposal would reduce the disparity between the effective tax rate and the nominal statutory rate on capital gains, our judgment is that it would more closely conform to the appropriate

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222 The “effective tax rate” is defined as taxes paid over “economic income,” by which we mean accrued income, whether or not realized.

223 For example, a proposal to tax only the imputed income of homemakers, would decrease the disparity between the effective tax rate and the nominal statutory rate, but nevertheless is probably inequitable because it fails to provide similar treatment to other forms of imputed income. The net result might be a worse alignment of tax burdens than under current law.

224 Indeed this is why the burden is appropriately referred to as the deadweight loss due to taxation.
distribution of the tax burden. The benefit of deferral reduces the rate on capital income below the rate on labor. But by lowering the nominal rate, the effective rate rises, thus actually reducing the disparity between the effective and statutory rates. Adoption of the Preference Proposal would bring the system closer to imposing the same effective rate of taxation on all income. Thus, in our view the Preference Proposal would be equitable. Even though the effective rate on capital would not be exactly the same as that on labor because the taxpayer can continue to hold the capital asset, this reform proposal should not be rejected simply because it fails to impose an identical tax burden on two taxpayers with equal economic income or because it does not conform to the standard chosen for designing an income tax.

The effects of this approach are not limited to capital gains. Consider, for example, a proposal to repeal the penalty for early withdrawal.
The reformulation would produce a different gauge of equality. Under the classic formulation, one might oppose the penalty's repeal because it would reduce further the tax burden on an already favored asset. Under our formulation, however, the repeal would not be opposed on the basis of equity. Existence of the penalty creates a type of lock-in effect. Removal of the penalty undoubtedly would increase withdrawals from IRAs. Indeed, it is quite possible that repeal of the penalty would generate more revenue than the penalty itself and have the result of increasing the rate of tax on those with IRAs. If this were so, although we might object to the repeal on other bases (undercutting retirement policies), we would not object to the repeal on equitable grounds because it would have the effect of decreasing the disparity of effective tax rates on funds invested in an IRA and those invested in other capital.

H. Conclusion

All serious arguments in support of a capital gains preference can be traced to deviations from the appropriate taxation of capital gains in a Haig-Simons income tax. In each case, the optimal solution is significantly better than a capital gains preference. In order to evaluate the preference, however, we have assumed that the optimal resolution of the problem is unavailable. Nevertheless, in almost all cases, the current form of a capital gains preference is an extremely poor second-best alternative.

As indicated, we do not think that bunching is a serious problem; in most cases, capital gains are realized by those already in the highest bracket; in many others, bunching is more than offset by the benefits of deferral. Even if it were consistently a problem, an averaging option could be devised that would be far superior to a capital gains preference. A capital gains exclusion is easily assailable as a substitute for indexing and cannot be supported as a solution for the erroneous taxation of inflationary gains. While we find that the current treatment of risky investments is troublesome, an untargeted capital gains preference shoots wide of the mark because it provides preferential treatment for nonrisky assets as well. Furthermore, to the extent an income tax does create a bias against risk, a gains preference, rather than a reconfigured loss limitation, may not remove the bias.

Section 72(t)(1) imposes a tax of 10% of the tax attributable to any amount received from a qualified retirement plan. A qualified retirement plan includes an IRA. IRC §§ 4974(c), 408. The additional tax is not imposed if the distribution is made on or after the date on which the employee attains age 59 1/2, so that the surcharge is a penalty for early withdrawal.
Use of the preference to mitigate the double taxation of corporate earnings is similarly misdirected. The current far reaching exclusion cannot be supported on that ground.

Even considering these problems in conjunction rather than separately, we conclude that a preference cannot be supported. Admittedly, inflation and the double taxation of corporate earnings present serious problems; bunching and risk may be problems. In combination, they present a threat to a realization-based income tax. But an untargeted capital gains preference does not accurately solve any of these difficulties and in some cases exacerbates them. The attractiveness of the preference is not increased simply because it is throwing stones at multiple targets and missing them all.

Lock-in often is perceived to be the most significant problem, but that may be because the preferable alternatives are thought to be unobtainable. Repealing § 1014 and taxing gains at death is better theoretically and less complex than a capital gains preference. It is only in the context of the lock-in effect, however, that a capital gains preference might be an acceptable second-best solution. If a capital gains preference pays for itself, it may very well promote efficiency, particularly if it were structured to eliminate some of its complexity. Although the possibility of such efficiency gains might be irrelevant for those who would judge a preference as offensive under the classic horizontal equity standard because it would not impose equal burdens on those with equal incomes, we do not count ourselves in that group. As a reform proposal, the preference presumptively would not be inequitable if it decreased the disparity in effective tax rates between two taxpayers with equal incomes. Thus, if the preference resulted in sufficient efficiency gains and actually improved equity by increasing the effective tax rate on the holders of capital, it would be an acceptable second-best alternative.

Ultimately, whether or not a capital gains preference, as a second-best alternative, is desirable depends on the resolution of two issues. First, the preference is only acceptable if, in fact, it promoted efficiency by increasing realizations to the level that permitted a rate reduction on ordinary income. As noted elsewhere, the empirical evidence is ambiguous and until such time as it becomes more definitive, the risk in relying on faulty evidence may be treacherous. Second, the preference is only a second-best alternative, and any support for an inferior solution may weaken the resolve for optimal solutions.231 Thus, a willingness to accept a capital gains preference should be linked directly to one's predictions about the political likelihood that Congress will repeal § 1014 or adopt an accretion tax.

231 See Halperin, Equal Treatment, note 175.
Previously, our principal concern has been whether a capital gains preference could be justified as part of a normative income tax. One argument, often offered in support of a preference, is not premised on its consistency with the Haig-Simons base, but rather as an intentional deviation. The argument is that the preference can be justified as a savings incentive designed to increase domestic investment and thereby spur the economy.\footnote{See, e.g., Council of Economic Advisers Annual Report 27, in Economic Report of the President 11 (1991) (arguing that a capital gains cut would increase long-term economic growth by stimulating saving, lowering capital costs and encouraging investment). But see Blum, note 131, at 393 ("Nor is the capital gains preference justifiable as an incentive to savings and investment."); Deborah M. Weiss, Can Capital Tax Policy Be Fair? Stimulating Savings Through Differentiated Tax Rates, 78 Cornell L. Rev. 206, 251 (1993) ("The focus on capital gains cuts as a savings incentive, therefore, seems to rest only on historical grounds.").} If valid and if an increase in domestic investment were a desirable goal, the argument might be a sufficient reason to enact a preference. Furthermore, a convincing incentive argument might tip the scale where the strength of the argument for a preference in a normative tax was uncertain. Thus, we briefly evaluate this argument.

The validity and strength of the argument depend on two propositions, neither one of which is free from doubt. These are: (1) Raising the rate of return on savings (by creating a preference) would increase the amount of private savings; and (2) an increase in private savings would lower the cost of capital and increase domestic investment.

We briefly examine these propositions below. In sum, the strength of this argument depends heavily on whether the capital gains preference would pay for itself through increased realizations. If it did, the preference also probably would spur economic growth. Even under the rosiest scenario, however, the amount of resulting economic growth would be modest\footnote{The study which shows the highest correlation between the rate of return on savings and the amount of private savings was done by Michael Boskin in which he found the correlation to be .4, that is, a 10% increase in the rate of return to saving would increase total savings by 4%. Tax Incentives for Increasing Savings and Investment: Hearings Before the Senate Comm. on Finance, 101st Cong., 2d Sess. 186 (1990) (statement of Michael J. Boskin, Chairman, Council of Economic Advisers); Michael J. Boskin, Taxation, Saving, and the Rate of Interest, 86 J. Pol. Econ. S3 (1978). All other studies show a lower correlation. See Joseph Cordes, Leonard Burman & Larry Ozanne, Capital Gains and Economic Growth, in Capital Gains Reader, note 14, at 203 app. at B 216.}. On the other hand, if the preference were funded through an increase in the deficit, then the preference might actually constrict, and therefore be antithetical to, economic growth.
A. Would Raising the Rate of Return on Savings Increase the Amount of Saving?

Most individuals must decide how much they should save and how much they should consume, a decision based, at least in part, on the expected return on the savings. A preference increases the after-tax return on savings and thus saving becomes more attractive as compared to current consumption. Thus, most economists believe that raising the rate of return would result in more private savings. Although this is generally true, the amount of the increase is not clear for at least two reasons. First, the rate of return on savings may not be the dominant factor in the savings decision. Economists believe that most savings decisions are based on lifetime considerations. Individuals tend to save while they are working so that they can consume during their retirement. For this reason, the capital gains preference may not increase the amount of private savings as much as one might otherwise expect. Indeed, one of the principal effects of the preference would be to reduce the taxes that retirees otherwise would pay during the years they are dissaving.

Second, some savers are target savers, that is, they save to accumulate a certain amount so that they could acquire something (for example, buy a car, make a down payment on a house, or the like). Target savers save until they reach their goal. An increase in the rate of return would enable these savers to achieve their goal more quickly and thus they might not continue to save thereafter, regardless of the rate of return.

These two factors make it difficult to determine both the extent to which an incentive generally would increase private savings and the extent to which a particular incentive (for example, a 28% maximum capital gains rate) would increase savings. For purposes of evaluating the argument, however, we assume that an increase in the return on savings actually would increase the amount of savings.

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234 Economists generally refer to this as the "substitution effect." Paul A. Samuelson, Economics 415 (8th ed. 1970); see Michael J. Graetz, To Praise the Estate Tax, Not to Bury It, 93 Yale L.J. 259, 282 (1983) (noting that savings is positively related to the real after-tax interest rate).

235 This is known as the life cycle theory of savings. See generally George R. Zodrow & Charles E. McLure, Jr., Implementing Direct Consumption Taxes in Developing Countries, 46 Tax L. Rev. 405, 439 (1991); Lawrence H. Summers, Capital Taxation and Accumulation in a Life Cycle Growth Model, 71 Amer. Econ. Rev. 533 (1981).

236 If the purpose of the preference actually were to increase savings, it should be limited to an exclusion of the gain on assets, the proceeds of which were reinvested. See, e.g., Blum, Rollover, note 131.

237 Economists generally refer to this as the "income effect." Samuelson, note 234, at 415.
B. Would an Increase in Private Savings Translate into an Increase in Domestic Investment?

Proponents of the preference as a savings incentive believe that an increase in private savings would result in an increase in domestic investment. The soundness of this proposition depends, inter alia, on whether the incentive was funded by an increase in the deficit and whether the United States is an open or closed economy.

To understand this dependence, we assume first, somewhat unrealistically, that the United States is a closed economy—one that does not interact with the rest of the world and therefore the rate of return on domestic investment is unrelated to rates of return in other countries. In such an economy, the demand for investment capital would be determined by the amount of savings in the economy. Since income is either saved or consumed, savings must equal investment. Algebraically, this is expressed as $I = S$. Increasing the amount of savings thus has the effect of lowering the cost of capital and increasing the amount of investment.

Savings, in this context, has both a public and private aspect. Where the government is running a deficit in a closed economy, domestic investment equals private savings minus the amount of the deficit, or $I = S - D$ (where $D$ is the deficit). Thus, a savings incentive that increased private savings (for example, the capital gains preference) would result in an increase in domestic investment only to the extent it was not offset by an increase in the deficit. To illustrate, suppose the enactment of the capital gains preference increased private savings of $100. If the preference paid for itself through increased realizations, this also would result in an increase in domestic investment by $100. On the other hand, if realizations did not increase sufficiently and the incentive resulted in an increase in the deficit, that increase would offset the increase in domestic investment on a dollar for dollar basis. Therefore, if the increase in the deficit exceeded the increase in savings, the savings incentive would decrease rather than expand domestic investment.238

238 This ignores the possibility of stashing savings under a floorboard.

239 Public savings occurs when the government reduces the deficit or invests in the country's infrastructure.

240 For example, if the increase in the deficit as a result of the incentive were $110, there would be $10 less domestic investment than there otherwise would have been in the absence of the incentive.

241 Several studies have indicated that a savings incentive may actually constrict economic growth. Ralph B. Bristol, Jr., J. Andrew Hoerner & Cathy Hubbard, Tax Association Conferees Cite Many Reasons (but Few Solutions) for Dismal U.S. Savings Rate, 47 Tax Notes 1163, 1164 (June 4, 1990) (citing, for example, a Congressional Budget Office study that found from 1982 to 1986, the existence of IRAs probably reduced total national savings by about 62 cents for each dollar of tax expenditure).
economy, the argument for a preference as an incentive also depends on the extent of increased realizations and whether they would be sufficient to avoid a revenue loss and thus an increase in the deficit. Given the confusion surrounding this empirical question, the case for the incentive is somewhat problematic.

The argument is more complex, and somewhat weaker if we assume the United States economy is an open economy, that is, one in which the supply and demand for capital are determined globally. Although the U.S. economy is probably not completely open, it is clear that it is no longer (if it ever was) a closed economy and thus an incentive based on such a premise is unquestionably flawed.

In an open economy, exports and imports—including capital—must be taken into account. In an open economy, domestic investment is equal to private savings (S) minus an increase in the deficit (D) plus foreign investment. Foreign investment (F) is equal to imports less exports, including capital. Thus, \( I = S - D + F \). Because the supply and demand for capital are determined by the world economy, an increase in domestic private savings would increase worldwide investment, but would have little or no effect on the amount of domestic investment. Domestic savings could be invested abroad (increasing exports) or it might displace foreign investment (decreasing imports). In either case, the increase in private savings would reduce the amount of net foreign investment (F). If so, increased savings would not increase domestic investment. The sole effect of savings incentives in an open economy might be to transfer wealth from nonsavers to savers.

As the U.S. economy is probably somewhere in between an open and a closed economy, an increase in private savings (not funded through an increase in the deficit) probably would increase domestic investment, but not on a dollar for dollar basis.

In summary, the argument that the capital gains preference would stimulate economic growth, although not frivolous, standing alone is not very compelling. Its validity is dependent on the extent to which

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242 See text accompanying notes 142-55.
243 For a good general description of an international capital market, see Joel S. Slemrod, Effect of Taxation with International Capital Mobility, in Uneasy Compromise, note 28, at 115.
244 An investment incentive—designed to create demand for capital by decreasing the after-tax cost of capital—is probably a much better way to increase investment in an open economy.
246 Richard N. Cooper, The United States as an Open Economy, in How Open is the U.S. Economy? 1, 3-10 (1986).
the preference actually increases domestic investment, which in turn is largely dependent on whether the preference would pay for itself through increased realizations.